Measuring Quality of Life: How should we assess improvements to our standard of living?
Economists and policymakers often use average income as a way to gauge a country’s “standard of living.” But income alone doesn’t capture overall quality of life. Should policymakers use other measures — including health, education, and even aggregate happiness — when making economic policy?

Postal Peril: The checks aren’t in the mail
Recession and a changing mail market have altered mail streams — especially first-class mail, over which the United States Postal Service has a monopoly. Despite cost-cutting, the USPS will face hard choices if it is to stay financially viable in the long run.

Health Care Aisle: Retail medicine pushes competition, price transparency
Medical innovation has allowed some routine health care to be performed in clinics located in retail stores. These outlets have created new competition that may affect the traditional ways health care is delivered.

A Matter of Antitrust: The debate over the role of government as referee of market competition
Antitrust laws were originally created to protect consumers against monopolies. Yet today many believe some market arrangements that might appear anticompetitive instead enhance the welfare of consumers.

Rip Currents: How the recession affected seasonal employment in one beach town
A decline in consumer spending cut the demand for seasonal workers in the tourism hotspot of Myrtle Beach, S.C., illustrating how overall business conditions affect seasonal employment.

DEPARTMENTS
1 President’s Message/Decentralization and the Fed
2 Upfront/Economic News Across the Region
5 Federal Reserve/Role of the Beige Book
8 Jargon Alert/Inferior Goods
9 Research Spotlight/You Get What You Pay For
10 Policy Update/Lack of Loan Modifications
11 Around the Fed/Safety First
28 Interview/Timur Kuran
34 Economic History/The Rescue of Long-Term Capital Management
37 District Digest/Economic Trends Across the Region
44 Opinion/A Case Against “Do Something” Policymaking
When people think of the Federal Reserve, many think of the Federal Reserve Board in Washington, D.C., or the Federal Reserve Bank of New York. And with good reason. The Board is ultimately responsible for much of what is done by the Federal Reserve System. And the New York Fed implements monetary policy by conducting open market operations that move the federal funds rate to the target established by the Federal Open Market Committee (FOMC).

In addition, during the recent economic and financial turbulence, both the Board and the New York Fed have received considerable media attention. They worked closely with large financial institutions, many of which are headquartered in New York, and did much to design and implement the Fed’s new lending facilities.

But as the article in this issue of Region Focus on the Fed’s Beige Book — a survey of economic conditions from around the Federal Reserve’s 12 districts — makes clear, the decentralized nature of the Fed is one of its major attributes. It allows each of the Reserve Bank presidents to bring timely, anecdotal information to FOMC meetings, information that may provide insights that official data releases do not yet capture. That can be very important at times, and we are grateful to the many contacts throughout our districts that share this information with us.

But the benefits of a decentralized system do not end there. It promotes information gathering, as I discussed above, while at the same time promoting information dissemination. Reserve Bank officials are able to meet and speak with their constituents about the economy and what the Fed is doing, and hear and address any concerns they may have. For instance, we have held several regional forums throughout the Fifth District since the financial turmoil began, learning the particular issues those areas face. It is hard to imagine how a more centralized system could as effectively engage communities facing disparate economic conditions. In effect, our structure permits us to have deep, ongoing discussions with the diverse economies of our districts.

A good example of this is the issue of foreclosure prevention. Although many communities are suffering from quite high rates of foreclosure, the reasons why those rates have risen often differ quite significantly from community to community. And, hence, the best way to address those problems also often differs. Staff from the Richmond Fed have provided information and counsel to community leaders active in helping individuals avoid foreclosure, something that I think would have been difficult, if not impossible, if we did not have firsthand, local knowledge of the areas. Former Speaker of the House Tip O’Neill was fond of saying that “all politics is local.” In many ways, I think that is true with the economy as well.

In a 1999 article, my former colleague Marvin Goodfriend, now of Carnegie Mellon University, made another point about decentralization that I think deserves special attention. A decentralized system allows Reserve Banks to have different research agendas — to not only focus on certain areas of economic research but also to have unique perspectives on those issues. To put it another way, a Reserve Bank can look at the economy through a particular analytical lens, which can often lead to quite different implications for public policy decisions.

This is useful in many ways, but perhaps the most important is that it increases the quality of debate at FOMC meetings. Prior to each meeting, Bank presidents meet with their research staffs to consider issues that will likely arise when the committee convenes. The input we receive during those sessions — along with the close, ongoing discussions we have virtually every day — enrich our understanding of the key issues facing the economy. The varied perspectives of the different Reserve Banks are brought to the FOMC, where they are advanced firmly but collegially. Ultimately this leads to better policymaking than if research were concentrated solely at the Board of Governors.

I have been at the Fed 20 years now. There are, in my opinion, still many unresolved questions facing central bankers. But one issue that I think can be stated with certainty is that a decentralized system is good for the Federal Reserve and ultimately our nation’s economy.
The latest battle over Internet taxation involved North Carolina and Amazon, the Seattle-based online retailer.

In 1996, Amazon initiated the Amazon Associates program by which Web site operators, or “affiliates,” earn money from product sales by posting ads that funnel customers to the parent site. Affiliates can earn anywhere from 4 percent to 15 percent of a product’s price through this referral program.

In response to budget woes, legislators in North Carolina proposed adding a sales tax to out-of-state online transactions of businesses with a physical presence in the state. However, the state lost its opportunity to generate revenue when major online retailers, including Amazon, preemptively canceled agreements with North Carolina businesses in late June, a month before the tax was signed into law. In an e-mail to affiliates, Amazon announced it would discontinue its popular Amazon Associates referral program if the state’s “unconstitutional tax collection scheme” passed.

North Carolina had previously required consumers to pay taxes on out-of-state purchases when they file their income taxes as a kind of “good faith” payment. But with most consumers either unaware of this tax or unwilling to pay, the state has lost approximately $145 million in tax revenue for 2008 alone. A legislative fiscal analysis projects up to an additional $13.2 million in fiscal year 2009-2010 on electronic commerce sales.

In 1992, the Supreme Court ruled that an out-of-state business must collect sales taxes only if a sufficient physical presence is established. Determined to reduce the Tar Heel State’s $6.4 billion deficit, state legislators plan to force out-of-state businesses with North Carolina-based affiliates to begin collecting sales taxes.

Since these Web site operators, often small businesses, are based in North Carolina, the law defines Web site owners who run ads as a form of physical presence for Amazon and others, as if they had a warehouse or storefront. The “sufficient physical presence” clause would consequently mandate Amazon to collect taxes on behalf of the state.

Not only has the state lost the potential revenue from these Amazon sales, but a significant share of the residents who relied on the affiliate program for business will have less income to report.

Rich Owings, owner of a Web site that reviews global positioning systems and refers customers to Amazon and other online retailers, realized he would lose 40 percent of his income the day Amazon terminated its program. The outlook for his business looks grim, and he said that his options are to sell the business, move out of state, or let it go completely.

The Amazon issue foreshadows the larger problem of a tax system coping with rapidly evolving technologies, according to Bill Fox, director of the Center of Business and Economic Research at the University of Tennessee. One potential solution involves changing the federal sales structure, an initiative known as the Streamlined Sales Tax Project. It would create a uniform tax rate and define what constitutes a “physical presence” for online retailers.

Though the consequences for state tax revenues are uncertain, Fox says, this won’t be the last time states will spar with online retailers over tax issues. Rhode Island, Hawaii, and New York have already passed such legislation, and more states may follow suit.

— CHRISTINA ZAJICEK
Renters’ Market

Apartment Demand Declines

Springtime typically brings out the movers — people upgrade dwelling spaces or form new households, especially young graduates entering the work force. Not this year. With the housing market in a slump, you’d think more people would choose to rent. After all, homeownership has declined to rates not seen in nine years. But apartment vacancies nationwide have reached a 23-year high of 7.8 percent through third quarter 2009, according to Victor Canalog, director of research at Reis, Inc., a real-estate research firm.

In the Fifth District, year-over-year vacancy rates in Greensboro-Winston-Salem grew by 3.9 percentage points to 12.6 percent; rates in Charleston, S.C., stand at 12 percent, a change of 3 percentage points. Apartment vacancies in Richmond, Va., rose by 2.5 percentage points from the same quarter a year ago, and now stand at 8.2 percent. Charlotte, N.C., vacancy rates are 10.5 percent, a change of 3.3 percentage points over the same period in 2008.

The slow economy has staunted new household formation, dampening demand for apartments among the largest tenant group, 18- to 24-year-olds. While 1.6 million new households formed in 2007, according to the Census Bureau, that number fell to 772,000 in 2008. “Clearly we are seeing a pullback in new households formed,” Canalog notes. “That is, basically, people leaving school and renting their own place.”

And, although demand has fallen, supply is growing. About 73,000 units have come online through third quarter 2009, with the total expected at about 100,000 by year-end. “If you’re a developer or lender obviously it’s to your advantage to open your doors,” Canalog says.

But there’s another reason for the high vacancy rate: unsold houses and condos. “A growing shadow market is undercutting the traditional rental market,” says Stephen Fuller, who tracks the trends for the Center for Regional Analysis at George Mason University.

Canaalog notes that the continued high vacancy rate, which stayed above 6 percent through 2008, has given landlords no choice but to cut asking rents in addition to offering concessions. Asking rent nationwide has fallen by 0.5 percentage point from the previous quarter while effective rents, which factor in offers of gym memberships or months of free rent, have fallen by 0.3 percentage point. The first half of 2009 saw the biggest decline in asking rents since Reis began reporting quarterly data in 1999.

Fuller notes that the “distortion in the housing market will work itself out over time.”

— BETTY JOYCE NASH

Dwindling Blue Crab Populations

Maryland and Virginia Offer to Buy Back Licenses

Too many crabbers with too many pots have prompted Maryland and Virginia to offer a voluntary buyback of state-issued licenses from some watermen. Maryland and Virginia have capped the number of crab licenses and limited harvests and seasons, among other measures, to cut harvest numbers and bolster the Chesapeake’s puny blue crab population, which has fallen by about 70 percent since the 1990s.

Officials say that retiring the capacity for potential harvests will help stabilize the fishery. Licensees got the chance to submit a bid to the Maryland Department of Natural Resources (DNR) in July to show how much they’d be willing to pay to permanently give up the licenses. The state offer brought 494 bids among the approximately 2,000 licenses targeted. The DNR countered with a bid of $2,260 per license to all commercial license holders.

Virginia offered to buy licenses from both full-time watermen who averaged more than 100 days with pots (or 60 days in the case of juvenile pots, also known as “peelers”) from 2004 to 2007 as well as part-time crabbers and people who were placed on wait lists for licenses in 2008.

It’s unlikely that a full-time crabber would bid, but some watermen might be ready to retire, says Rob O’Reilly, a fisheries biologist with the Virginia Marine Resources Commission. “The crab pot and peeler pot fisheries — those together are getting 90 percent of all the harvest,” he says, adding that’s why they are attractive targets for buybacks.

Crabbers submitted a total of 665 bids to the Virginia Marine Resources Commission. Bids will be accepted or rejected by December 1. Once the state buys a license, it’s permanently retired.

Virginia and Maryland in 2008 reduced allowable female catch by 34 percent, and the 2009 Winter Blue Crab Dredge Survey reported increasing numbers of year-old females.

— BETTY JOYCE NASH
Unemployment Trust Funds
States Borrow to Pay Benefits

At least 23 states and territories — including three in the Fifth District — have borrowed or will borrow from the federal government to pay unemployment benefits.

In most states, taxes on employers fund unemployment trust funds. Employers pay taxes on a portion of each worker’s salary, and those tax payments usually depend on the number of workers the firm has collecting unemployment. States with insolvent trust funds aren’t collecting sufficient tax revenues to continue paying out benefits.

“I’m not surprised to see stress at the time of a severe recession,” says economist Bill Conerly, a consultant and expert on unemployment trust funds.

The most troubled states are those with taxable wage bases that aren’t keeping up with the growth in the economy, says Rich Hobbie, executive director of the National Association of State Workforce Agencies in Washington, D.C.

“The problem is really on the tax side,” Hobbie says. “What we see historically in the system is the benefit side is a little better indexed to growth in the economy than the tax side.”

Maryland is one state not borrowing to pay its unemployment benefits. Annual reviews determine the taxes that employers in the state will pay for the following year.

“It’s structured such that we hope to avoid borrowing federal money,” says Tom Wendel, unemployment insurance assistant secretary.

At press time, the borrowing states and territories had received more than $17 billion in federal loans. Seven states have borrowed about $1 billion. Borrowing states won’t face interest charges until 2011 under the stimulus bill.

North Carolina had borrowed more than $1.2 billion, according to the U.S. Department of the Treasury. The state started borrowing in February 2009 for the first time since 2003, says David Clegg, chief operating officer of the North Carolina Employment Security Commission. Before the current recession, North Carolina was working to rebuild its trust fund. “Had normal economic events occurred, we probably would have been OK — we have been in the past,” Clegg says.

South Carolina has borrowed about $564 million, according to the U.S. Department of the Treasury. Virginia was scheduled to begin borrowing in October. The commonwealth won’t see its unemployment trust fund solvent again until 2013, says Dolores Esser, commissioner of the Virginia Employment Commission. Virginia expects to borrow $1.23 billion.

This isn’t the first recession during which states have borrowed from the federal government to pay unemployment benefits. In the late 1970s and early 1980s, there was a worse “borrowing crisis,” Hobbie says. Larger amounts were borrowed, but they were paid back by the end of the 1980s. “I think to some extent as a nation we were lulled into a false sense of security in the 1990s,” he says.

Employers will likely face higher taxes in the future as a result, Wendel says. “No matter what happens, to get the trust funds back up to what you would consider a good solvency level, employers are going to have to pay extra taxes over the next one, two, three, maybe even more years, depending on how long higher payouts occur.” But in North Carolina, Clegg says it’s going to be difficult to ask employers to cover a $1 billion shortfall.

Insolvency of state unemployment trust funds may have a small impact on hiring decisions, Conerly says. While taxes on employers fund benefits, ultimately employers don’t foot the bill. “Virtually the whole tax is passed on to employees in the form of lower wages,” he says.

— David Van Den Berg
The Beige Book is a survey of economic conditions published by the Federal Reserve eight times each year. The survey consists of perspectives on economic conditions from business leaders throughout the country who together help build a picture about the health of the overall economy.

The Beige Book is often the most current source of information covering overall economic activity that members of the Federal Open Market Committee (FOMC) have access to when they convene to set monetary policy. Thus, how well this anecdotal survey actually reflects current conditions and near-term trends is potentially important.

At first blush, some are skeptical of the value of a resource that is almost purely anecdotal. Princeton University economist Alan Blinder, who served as vice chairman of the Federal Reserve Board from 1994 to 1996, once famously wrote, “There are two basic ways to obtain quantitative information about the economy: You can study econometric evidence, or you can ask your uncle.” He thought there was too much uncle-asking going on in government and central banking, which he said risks letting one’s prior beliefs “run rampant.”

Despite the doubts of some, the Beige Book has existed as a resource for policymakers for nearly 40 years and has been available to the public for the majority of that. What informational value does it actually provide?

When Data Fall Short
Before each FOMC meeting, the committee members are briefed extensively on aggregate economic conditions, regional developments, financial markets, and international economic conditions. In addition, much of the ongoing economic research conducted within the Federal Reserve System contributes to policymakers’ and economists’ general understanding of how the economy operates, which is critical for understanding how monetary policy may affect the economy. It is safe to say that policymakers arrive at FOMC meetings having done a lot of homework.

Still, monetary policy is often made under a considerable amount of uncertainty. Economists have an incomplete understanding of how monetary policy decisions work through the economy. And even if models of the economy are robust, the data on which they rely can be incomplete or unavailable at the time policy is made.

For example, data on gross domestic product — the broadest measure of aggregate economic activity and arguably the foremost gauge of the economy’s health — are tracked by quarter. It takes a full month for the Bureau of Economic Analysis to gather enough of the thousands of data points that comprise the GDP number to release the first, “advance” estimate. Two revisions follow, with the “final” GDP number being published a full three months after a quarter has ended. And that’s just one number — policymakers also care about a wide array of other data series, such as inflation and employment. Fortunately, some of these data arrive with greater frequency than GDP. Still, if an FOMC meeting falls at the end of an estimation cycle, the information policymakers have is somewhat old. That is when anecdotal data can be particularly helpful in filling in some gaps.

Former Richmond Fed President Al Broaddus says that if Fed staffers sample enough opinions, the Beige Book actually might provide a fairly reliable hint at the likely future course of the economy. “You have a huge number of people reporting. Each Beige Book includes comments from directors and all other contacts, well over 100 people per bank, times 12 regional banks — that’s a very good sample.”

Still, anecdotal reports must be taken with a grain of salt. “You’re
Confidential details, such as the names of specific companies, might mask what percentage have your inventories dropped this month? This freedom helps each Fed design its questions around what best accommodates the size and industry composition of its district. For instance, you wouldn’t likely discuss wage pressures with contacts in agriculture in the Kansas City Fed’s district in the same manner as you would tech leaders in San Francisco’s.

The appeal of the Beige Book is its breadth, depth, and timeliness. Even though it gathers broad impressions on the economy with almost no reliance on data, it can also provide more information than data alone, such as an explanation of a slowdown in hiring or a buildup of inventories.

This can be instrumental for the Fed staff who brief Bank presidents before policymaking sessions, says Rick Kaglic, a regional economist in the Charlotte branch of the Richmond Fed. “Anecdotal information is kind of a uniting factor between data points.” When you’re looking at indicators in isolation, it’s like trying to figure out what water is by looking at individual hydrogen and oxygen molecules, he says. “Anecdotal information helps you step back and see the whole ocean.”

But How Predictive Is It?

Does the Beige Book accurately anticipate economic trends? A 2002 paper by Nathan Balke and D’Ann Petersen, of Southern Methodist University and the Dallas Fed, respectively, is one of the seminal studies on this topic. The authors were interested in how well the Beige Book tracks national economic growth (leaving aside other important data series like inflation or financial market conditions, which the Beige Book also covers).

Balke and Petersen independently read the Beige Books spanning back to 1983, when they were first published, and assigned numeric values to the economic conditions described in the reports. “We tried to quantify these anecdotal reports by scoring them,” Petersen explains. Evaluating the qualitative Beige Book in a quantitative manner is one of the major challenges in assessing its accuracy. For example, a statement that the economy was growing “very strongly” would receive a higher rating than one claiming “moderate” growth, while reports of economic contraction received negative scores. Then they created three Beige Book-generated measures of national economic conditions: the average scores of the 12 regional summaries, the average scores of the sectoral summaries included in the District reports, and the scores of the national summary itself.

The authors found that each of these measures tracked aggregate economic performance very well. “Just plotting those scores against GDP, you could see they were following it pretty closely. Then we ran some regressions and found it explained GDP well,” Petersen says. The authors also found that the Beige Book was better at predicting next-quarter GDP than other measures available to policymakers at the time, such as the popular Blue Chip consensus forecast.

If the Beige Book is indeed predictive of real-time economic activity, then it has the potential to be especially...
useful when the data turn out to do something unexpected. “We may report stories that indicate that there’s going to be new hiring, for example,” says Rubén Hernández-Murillo, a St. Louis Fed economist, who helps create the original Beige Book reports for that district. “That would be an indication of a turn in the labor market, and this is before any of the hiring takes place. It will come out as good news in the Beige Book report, even though that may not be what’s reflected in the employment series for that month.”

This means anecdotal information can help signal to analysts a turn in the business cycle. Forecasting models have a hard time predicting business cycle turns because those cycles are, by definition, a deviation from trend. As a result, write Balke and Petersen, anecdotal information sources have the potential to do a better job predicting changes in the business cycle because they reflect activity that is happening now and come straight from active market participants, regardless of past trends.

When policymakers receive an indication that the economy may be approaching a turning point in the business cycle, they can begin to envision an appropriate change in policy. The target federal funds rate, the Fed’s primary policy tool, may need to change if it appears the business cycle is turning. With that advance knowledge, the Fed can begin to communicate that likely change in the course of policy to the public in speeches and policy statements.

Recently, Fed officials have increasingly discussed the Fed’s “exit strategy” for the various lending facilities it has established to address liquidity constraints stemming from the financial market turbulence that began in 2007. Forming better estimates of when the recession is approaching its trough will be critical as the Fed forms this strategy.

At the same time, though, the survey’s subjective nature can be a hindrance for predicting business cycle turns. It is possible that the Beige Book could reflect speculation on the economy’s health propagated in the news and in business circles rather than on actual recovery in economic fundamentals, Broaddus cautions. “It could give you false signals. The information contained in the Beige Book is early and broad-based, but at the same time there’s this bandwagon effect that surrounds economic turning points that means it may not be right.”

Also, while the timeliness of the Beige Book is helpful to the Fed in real-time policymaking, it’s not clear whether it is the best available alternative to hard data. Even though it is a more timely resource than many data series, a group of Minneapolis Fed researchers found in a 1999 study that the Beige Book provides little information about current economic conditions that is not already captured in private sector forecasts. Private forecasters have a strong economic incentive to make their forecasts extremely accurate, Arthur Rolnick, David Runkle, and David Fettig write, so there’s no reason to expect they don’t also seek out unconventional information sources as well to improve their forecasts. Since those forecasts often outperform the Beige Book in predicting economic activity, the authors suggest Fed policymakers should look to private forecasts more frequently for real-time information on aggregate economic activity.

Still, the Minneapolis Fed authors write, “There are times when the most sophisticated economic models can’t bring insight to a current economic phenomenon. In such an instance, asking your uncle may provide helpful insight.” Anecdotes from business contacts, such as those collected in the Beige Book, show up repeatedly in the transcripts of FOMC meetings, revealing that policymakers clearly utilize that information for real-time guidance.

When it comes to understanding the economy, Petersen of the Dallas Fed says, a “more information is better” approach might be useful. “We would never advocate doing everything based on anecdotal data, but it is very helpful, especially in turning points when data can be lagged and are revised,” she says. “As long as we view it as just another tool in addition to the other measures that are available, it’s wonderful to have as much information as you can. The Beige Book is just another piece of information that policymakers can use, especially in times of uncertainty.”

And the fact that the Beige Book provides a mechanism for collecting and reporting anecdotal information in a systematic way is especially important, says Broaddus. It carefully filters information that otherwise could come at policymakers from multiple directions, providing little guidance about which trends are broadly observed and which may be unique to just a few sources. “The Federal Reserve is always going to get anecdotal information from businesspeople, and that’s a good thing because the Fed needs to not be isolated from the public,” Broaddus says. “But if it influences policy in an unsystematic way, that could be a problem. One of the great benefits of the Beige Book is that it puts all the information in one place, synthesizes it, and churns out which way the wind is really blowing.”

**Readings**


When the economy is in recession and incomes fall, there are certain items people may naturally choose to consume less of to save money. For example, people might take fewer vacations or be less inclined to buy an expensive pair of shoes.

People may substitute for those things instead by increasing their consumption of less expensive goods. Imagine that you cut expenses by taking the family out for hamburgers instead of prime rib. Or if you save money by giving up that season pass to the opera, you will still have leisure time to fill so you might rent more movies to watch at home. In these cases, your reduced income has actually increased your demand for hamburgers and movie rentals.

Those goods you buy more of when your income goes down are called “inferior goods.” In economics, an inferior good is one for which the “income elasticity of demand” — how much you change your demand for the good in response to a change in your income — is negative. In other words, you will buy less of an inferior good when your income increases and more of it when your income goes down. In contrast, demand increases for “normal goods” when income rises, and it falls when income declines.

But don’t misunderstand the phrase. Calling a good “inferior” isn’t a description of its quality per se. The name is not meant to imply that the product is somehow defective, or even that many people don’t enjoy it. It simply describes the demand for a good as income changes.

A recession is an interesting time to think about inferior goods because we might see the incomes of large groups of people falling — a natural environment for identifying inferior goods. For example, we would expect that sellers of inferior goods would thrive during these times. Wal-Mart, the low-cost retail chain, has generally outperformed its retail contemporaries during the recent recession.

Perhaps this shouldn’t be surprising. In a recent paper, University of Missouri economist Emek Basker found that demand increases for the products sold at Wal-Mart when disposable personal income falls, while demand for products sold at Target, a generally higher-priced competitor, has tended to fall in bad economic times. Basker says this suggests that for the average consumer, purchases at Wal-Mart are inferior while purchases at Target are normal. This is either because there are a greater number of households who view shopping at Wal-Mart as an “inferior” activity, or because those who view it as inferior have a larger elasticity of demand than households that view it as normal.

It’s easy to think about inferior goods in terms of food items. People must make constant choices about what to eat, providing frequent data points on shifting consumption bundles as incomes change. It is no surprise that as demand for restaurant services — something generally thought of as a normal good — has fallen during the recession, grocery stores have thrived. This means that relative to restaurants, grocery store products may be inferior goods.

There is a special case of an inferior good for which the income effect associated with it is so strongly negative that when the price of that good rises, you actually demand more of it. (Note that this idea is quite separate from a “luxury good” that people may demand more of precisely because it is expensive and thus associated with status.) This is called a Giffen good, named after the economist Robert Giffen who may have first observed the concept in the mid-19th century. Giffen goods are typically discussed in connection with extreme poverty. It could be something that is an important enough part of the consumption bundle of very poor people and for which there are no close substitutes — like the basic staples of rice and noodles in some Asian countries — that when its price increases, people are made to feel even poorer. This prices them out of the market for more expensive food, leaving the staple as the only affordable option. As a result, they may end up consuming even more of that inferior good to keep their caloric intake relatively constant. In other words, for a Giffen good the demand curve actually slopes upward.

Potatoes during Ireland’s Great Famine of the 1840s have long been considered a possible Giffen good. As the blighted potato supply increased potato prices, people consumed even more of them. But this behavior would be so at odds with consumer theory that economists have questioned whether that was the whole story. A perhaps more plausible explanation is that people were simply hoarding potatoes out of fear of starvation, or that maybe the price of a substitute good, like bread, had also shifted. Economists can’t be sure Giffen goods even exist except in extraordinarily unique situations.

While the possibility of Giffen goods may ultimately prove no more than a theoretical curiosity, the more conventional definition of inferior goods remains well-established today.
When the government tries to measure inflation by constructing the Consumer Price Index (CPI), it must distinguish between a change in the overall price level of the goods surveyed and a change in the relative prices between those goods. The issue is further complicated by recognizing that quality changes in the good will occur over time. For instance, when a new model of a computer hits the market, it may be priced higher than the previous model because of its increased functionality and speed. If the government decides to count that as an increase in the overall price level for computers — that is, attributes it to a rise in overall inflation rather than in quality — it overstates the general rise in the price of computers. Instead, a better comparison would be between two comparable computer models.

Mark Bils, an economist at the University of Rochester, took a look at the datasets used to construct the CPI between 1988 and 2006 to determine whether inflation was overstated because of a failure to fully adjust for quality improvements in goods. To understand his methodology, it helps to know how the CPI is constructed. The Bureau of Labor Statistics (BLS) tracks the prices of about 90,000 nonhousing goods and services each month. Because consumer habits change, roughly every four years the BLS draws a new sample of stores and products within a geographic area to better reflect current spending. These are called scheduled rotations.

If the BLS continues to keep track of a particular product after a scheduled rotation, it has to make adjustments when a product model stops being carried by the stores in the survey. In that case, the BLS has to use another model by way of comparison. Bils calls these “forced substitutions,” and they occur nearly once per year for consumer durable items, such as computers, furniture, bicycles, or sewing machines, just to name a few.

Bils finds that scheduled rotations generate a price increase of just over 2 percent annually, while forced substitutions usually lead to price increases of nearly 4 percent. Yet rotations and forced substitutions are treated differently by the BLS. As Bils points out, both reflect the same economic phenomenon — older goods being replaced by newer goods that typically sell at higher prices. When a rotation takes place, the changes in price are implicitly treated as a change in quality. By contrast, forced substitutions directly compare prices between the new and old versions of the good, and the implicit assumption is that they vary little in quality.

Bils’ analysis suggests that two-thirds of the price increase for new versions of goods should usually be treated as quality growth, not inflation. This translates to an overstatement of inflation for durable goods by 2 percentage points during the time frame studied.

Additionally, this CPI data are used in the government’s measurements of productivity growth. If a change in quality goes unrecognized in the CPI data, it also fails to show up in the productivity data. Bils concludes that this implies U.S. productivity has been routinely understated by 2 percentage points per year as well.

To test the premise that the price increases mostly indicate changes in quality instead of overall price inflation, Bils analyzes how consumers react to the price changes. He takes a look at automobiles — goods that are frequently subject to forced substitutions by the BLS — to determine how the price increases affect market share.

Bils employs a standard assumption: If the higher price of a new good does not indicate an increase in the good’s quality, that good will lose market share relative to cheaper versions of the same good as buyers flock to the cheaper product instead. In the case of automobiles, the forced substitutions in the BLS data correspond to an increase of 14.2 percent in market share. In fact, a price increase in an old model actually causes a reduction in the market share for comparable vehicles, just as you might expect. Thus, the price increases seen in the data after the forced substitution by the BLS are most likely the result of an increase in quality: Many consumers would not be interested in buying a higher-priced car if it didn’t include more desirable features.

The results of Bils’ analysis have obvious implications for monetary policy debates. The Federal Reserve is mandated to pursue price stability and maximum employment. Experience has shown that those goals are complementary: Low and stable inflation is crucial to economic growth and a well-functioning labor market over the long run. Making sure we have an accurate picture of how prices react to changes in technology is vital to the task of pursuing a policy consistent with the Fed’s objectives.
Foreclosure notices have been filed on about 6 million American homes since January 2007, according to RealtyTrac. To try to reduce foreclosures, the federal government has implemented multiple programs. They include bringing borrowers and mortgage servicers together, reducing monthly payments and interest rates, extending loan terms, and delaying or reducing principal. President Obama announced in February the most recent government action, a mortgage loan modification and refinancing program called “Making Home Affordable.”

Making Home Affordable gives mortgage servicers an upfront payment of $1,000 for each successful modification after completion of a trial period and “pay for success” fees of up to $1,000 per year for up to five years if the borrower remains current. Homeowners may also earn up to $1,000 a year for five years for principal reduction if they stay current and pay on time. Refinancing would also be available, but borrowers may face higher payments when switching from adjustable to fixed-rate mortgages.

For the modification program, borrowers must have a monthly payment greater than 31 percent of their monthly income. For the refinancing program, the mortgages must be guaranteed by Fannie Mae or Freddie Mac and the borrower cannot owe more than 125 percent of the home’s current value on their first mortgage.

To date, the U.S. Department of the Treasury has signed contracts with more than 45 servicers to participate in Making Home Affordable. Between loans covered by those servicers and loans owned or guaranteed by Fannie Mae and Freddie Mac, about 85 percent of loans in the country are covered by the program. But since the policy took effect, only 12 percent of eligible borrowers have modified their loans.

A Boston Fed paper finds that fewer than 8 percent of seriously delinquent borrowers have had their mortgages modified since 2007. For a lender, the decision to modify a loan is a gamble for two reasons. First, about 30 percent of delinquent loans will “self-cure” — meaning the borrower will eventually be able to make the existing payments — without modifications. Second, a significant number of borrowers whose loans are modified will default again. “Finding profitable modifications is not nearly as easy as it looks,” says Paul Willen, a Boston Fed economist and a co-author of the paper.

Also, the choice between foreclosure and modification isn’t the only one lenders and borrowers face. “Short sales,” in which the lender agrees to take a loss on the property, and deeds in lieu of foreclosure, where the borrower hands over the deed of the property to the lender, are alternatives. In these cases, lenders often agree not to seek deficiency judgments against borrowers. In states where lenders have more options for collecting money owed by borrowers, economists Andra Ghent and Marianna Kudlyak find in research published by the Richmond Fed that these options are usually exercised more frequently and the probability of default through foreclosure is also lower.

Still, in some cases, foreclosure may be rational for borrowers, lenders, or both. A borrower with sufficiently negative equity, for instance, might be better off to walk away from the home.

Foreclosed properties can become run-down and have a negative effect on neighborhoods in which the property is located. The negative externalities that result from these foreclosures — including the decline in value of surrounding houses in the same neighborhoods — might be big enough to warrant government intervention, says Chris Foote, an economist at the Boston Fed. The trouble comes in designing a program to mitigate these potential problems without causing other problems, such as encouraging people who don’t need modifications to apply for them.

Pinpointing the reason borrowers fall behind on mortgage payments would help in designing better programs aimed at avoiding foreclosure. Economists disagree about the causes of America’s increase in foreclosures. Foote and co-authors suggest in a separate Boston Fed paper that the crisis stems from household income drops and an unprecedented fall in house prices. What’s really needed is significant but temporary assistance rather than the moderate and permanent assistance offered by loan modification. “The right policy would be to extend unemployment insurance benefits or make direct transfers,” Foote says.

Atif Mian, an economist at the University of Chicago, acknowledges that job losses and other negative income shocks are important factors in rising foreclosure levels. But those aren’t the biggest reason for the large number of foreclosures. Indeed, default levels started rising before unemployment did. “The problem really started with an overleveraged household,” he says. Therefore, the only solution for helping borrowers in trouble now is to reduce the principal on their mortgages, Mian says. That’s a painful process that involves changing contracts.

To proponents of loan modification programs, renegotiation of mortgages is “a type of public policy holy grail,” write Willen and co-authors. That’s because modification policies help borrowers and lenders at little or no cost to the government. While the effectiveness of current programs is still to be determined, policymakers would do well to monitor them and the changes in borrower and lender behavior.

In general, past studies have found that non-native workers are not more likely than U.S.-born workers to hold jobs with dangerous conditions. In this paper, economists Pia Orrenius and Madeline Zavodny cite large immigrant flows, a relative decline in immigrants’ skills, and until recently a boom in building construction (a relatively risky profession that employs considerable immigrant labor) as contributing to a rise in hazardous working conditions for immigrants. The authors found an immigrant-native difference in average industry fatality rates of 1.79 deaths per 100,000 workers. Additionally, immigrant women tend to work in environments with significantly higher injury rates than native-born women, while immigrant men often work in industries with higher fatality rates than native-born men.

Poor English language skills are correlated with higher injury and fatality rates. Immigrants also may face limited employment options and, consequently, be more willing to accept riskier occupations. The authors suggest that providing safety training in languages other than English and illustrated safety guidelines may reduce the number of injuries and deaths among immigrant workers.


Despite improvements in communication technology, physician treatment choice tends to be relatively uniform within geographic regions, yet quite diverse across regions, leading some observers to argue that national standards for care should be adopted. In this paper, economists Mary Burke of the Boston Fed, Gary Fournier of Florida State University, and Kislaya Prasad of the University of Maryland argue that region-specific patterns of care result from social interactions among physicians.

Physicians may learn and acquire skills from their peers, a phenomenon known as “knowledge spillover.” They may also yield to “conformity pressure” and adhere to local practice norms. Standardization may be harmful if knowledge spillovers are present because certain patients will be deprived of gains from specialization. Conversely, under conformity pressure, there is a tendency to over- or under-utilize some treatments in certain geographic locations, contributing to inefficient care and high costs. The authors argue that their empirical work, using data from Florida hospitals, “suggest that knowledge spillovers, rather than conformity effects, are the primary source of treatment variations in our data.”


Since the mid-1990s, the number of public firms that have delisted and gone private has increased sharply. Hamid Mehran and Stavros Peristiani of the New York Fed investigate the underlying causes of this trend.

Many factors must be considered in the decision to go private or public. Publicly owned firms can access debt and equity markets more easily, a process facilitated by sufficient analyst coverage. However, along with the benefit of increased financial visibility, publicly traded firms also must face the explicit and implicit costs of listing fees, disclosure, and the threat of litigation.

The authors argue that a driving force behind the decision of public firms to go private is a failure to attract a critical mass of analyst coverage and investor interest. This lack of financial visibility can create investor uncertainty and may produce an illiquid stock susceptible to mispricing. At the same time, the company must bear increased regulatory costs and shareholder scrutiny. Therefore, “firms with declining or smaller-than-anticipated analyst coverage, falling institutional ownership, and low stock turnover exhibit a substantially higher probability of going private.”


Traditionally, employment has rebounded quickly following a severe recession. Will that be the case this time? Edward Knotek and Stephen Terry of the Kansas City Fed argue that unemployment may remain relatively high, even as the economy begins to show other signs of recovery. Changes in the nature of layoffs and the rise of just-in-time labor practices appear to have contributed to “jobless recoveries” following the last two recessions and may contribute to continued weak employment numbers following the current downturn. In addition, this recession coincides with a banking crisis. International evidence suggests that such episodes are associated with high and persistent unemployment rates.
How do you know when a country’s “standard of living” has improved? Economists often use average income, as measured by real (inflation adjusted) gross domestic product (GDP) per capita, as a gauge of a country’s current standard of living and changes to that standard over time. This seems to make sense: Income is what allows us to buy necessities and indulge in luxuries. Average income is also a widely available way for economists to analyze living standards, as it allows comparisons across time and different countries.

But do measures like average income, relatively easy for economists to crunch, really illustrate the quality of life in a country? In 1968 politician Robert F. Kennedy succinctly proclaimed that measures of income tell us “everything, in short, except that which makes life worthwhile.” What he likely had in mind is that income alone does not capture qualitative aspects of life, like how safe we feel, or whether we have the freedom and ability to do things to improve our own quality of life.

So if measures other than income might help define our overall quality of life, should policymakers consider them when crafting economic policy?

**A Measure of Well-Being**
At its core, economics is largely about how people strive to make their lives better. As individuals trade and transact with each other out of self-interest, economists assume they are “utility” maximizers. Anything you do is meant to give
you as much utility — happiness or fulfillment — as possible.

Eighteenth century philosopher Jeremy Bentham was the first to use utility as a way to judge the value of public choices too. To the “utilitarians” like Bentham and his protégé, John Stuart Mill, a polymath who was trained in classical economics as well as philosophy, what made some laws and policies undesirable was that they failed to increase the utility of the population as a whole. Instead, they said, governments should choose policies that provide “the greatest happiness for the greatest number.” In other words, governments, too, should aim to maximize utility. But this raised an obvious question: What does utility look like in the real world, and how do we measure it?

Economic theory can explain why economists tend to equate utility with income. “Revealed preference theory,” first developed in the late 1930s and 1940s, is based on the assumption that if you opt to go out to dinner instead of seeing a movie or using that money to purchase anything else (including items bought in the future), then your choice is the one that you estimated would best maximize your utility. Because people optimize, the theory goes, observing your actions — that is, your revealed preferences — is a way for outsiders to identify what is in your best interest. Because you will use an increase in income to further pursue those interests, economists generally believe policies that increase income will also increase utility or welfare. Tracking economic growth is therefore a way to gauge improvements in welfare.

There are criticisms of income as a measure of well-being, however. One is simply how GDP is measured and what it really captures. On a national scale, economic growth can create negative externalities that GDP figures ignore. Environmental degradation is a good example. Production that creates pollution imposes a cost on society that may not be priced into the cost of production itself. That means the true “social” value of that production is overstated by GDP.

National wealth statistics also miss some positive elements, such as what economists call “consumer surplus.” Economist Justin Wolfers at the University of Pennsylvania has done some serious thinking about this issue. He estimates that TiVo — a device that allows the user to digitally record television shows for future playback and lets the viewer zip past the commercials — saves the average TV watcher the equivalent of thousands of dollars a year in time efficiency. The price is only the couple hundred dollars per unit that is reflected in GDP. “What we do to calculate GDP is value everything by what we pay for it,” Wolfers says. “But if you were to ask people what they would pay, then you get a measure more like well-being.”

The Root of All Utility?
Even if we could perfectly adjust GDP to account for “bads” and “goods” like negative externalities and consumer surplus, there may still be more to cultivating well-being than maximizing income variables.

Broader ideas of well-being reach as far back as Aristotle’s ideas on human happiness. To Aristotle, happiness meant flourishing by achieving one’s full potential and living a truly good and meaningful life. To determine whether someone has achieved that requires knowing more than what his paycheck looks like. So what does revealed preference theory miss when measuring well-being? Behavioral economists focus their research efforts on exploring this question.

Instead of assuming people are rational — that they make decisions through optimization and reason — behavior economics tests rationality through observation and social experiments. According to Harvard behavioral economist David Laibson, “The behavioral approach agrees that people often get optimizing right, but that in many important cases people get things wrong. There’s a gap between what really is in our best interest and the behavior that we in fact pursue or in fact achieve.” A quintessential example is a person who has the means to save money but fails to save sufficiently for retirement. That could be because he underestimates the hardship that doing so may present to his future rather thanrationally anticipating that hardship as neoclassical economics would suggest. Because factors such as emotion and lack of information can make it hard to figure out one’s own best interest, someone may sometimes resort to simple behavioral rules instead, some of which may not result in an optimally efficient outcome. This can create a gap between a person’s actions and what is truly best for him in the long run. Once one embraces the possibility of that gap, the classical revealed preference approach begins to founder a bit, Laibson says.

For instance, many people believe that a higher salary will improve their well-being, but when they get that pay raise, they find that just the opposite occurs. Increased income can intensify a never-ending jog on life’s “hedonic treadmill,” whereupon a rise in income only increases a person’s material desires and expectations. This effect would cause people to chase ever-increasing salaries, which lead to new, greater material desires, thus providing no major gain in utility on balance. These people tend to be more interested in their “relative position” — how they fare compared to their neighbors and friends, some of whom will almost always be richer — rather than their absolute condition. Under these circumstances, a country with a growing economy may include a substantial number of people who are experiencing that income growth but are not necessarily benefiting from it — for instance, made happier by it.

These ideas question the economics profession’s reliance on average income and economic growth as measures of a country’s well-being. “To the extent that you believe people clamoring after ever greater salaries might not be acting in their best interest, if you were skeptical of revealed preference theory you might also be skeptical of this pursuit of ever greater riches,” Laibson says.

Income measures can miss facets of life like health and education. Since 1990 the United Nations has produced the Human Development Index (HDI) in an attempt to
measure both social and economic development in countries by combining income, educational attainment, and life expectancy into a single index. It is true that GDP is highly correlated with these other aspects of life quality — the UN estimates that income explains as much as half of the variation between countries in the health measures included in the HDI, for instance — but income doesn’t explain it all, and there are exceptions. “There are areas of Africa that have essentially never grown, where literacy rates have been going through the roof, but child mortality rates through the floor,” points out Charles Kenny, a Washington, D.C.-based development economist.

If You’re Happy and You Know It
What alternatives do we have to using income to measure the standard of living? One approach is to survey people directly about their quality of life. Such studies on “subjective well-being” have the benefit of potentially collapsing several aspects of life quality into one variable.

In a 2008 paper, Wolters and economist Betsey Stevenson, also from the University of Pennsylvania, studied subjective well-being data and came to three conclusions. First, within a country, rich people tend to be happier than poor people. Second, the inhabitants of rich countries are happier on average than poor countries. Finally, the inhabitants of countries actually get happier as they get richer: In other words, average happiness rises over time with economic growth. Money seems to indeed “buy” happiness — or, at least, correlates closely with it — more in line with traditional neoclassical ideas regarding revealed preferences.

The result that economic growth over time is associated with rising average happiness was actually quite controversial. It appeared to overturn the famous Easterlin Paradox, named for its founder, economist Richard Easterlin. He found in the 1970s that, over time, average happiness levels in a country don’t improve as the country gets richer. Easterlin hypothesized at the time that this suggested a strong role for how people view relative income in determining their happiness. Research indeed seems to suggest that people largely use their peers as a frame of reference. As the economy and incomes grow, the material standing of your peers grows along with your own, with the result being no change in your relative status.

In contrast, Wolters and Stevenson’s study on aggregate happiness implies a smaller role for policy to focus on relative income and instead a greater emphasis on absolute income. All told, it is probably the case that both absolute and relative income play a role in happiness.

The ability of survey measures to grasp aspects of well-being that concrete measures like income can’t capture is a big part of their appeal. Yet it can also be a hindrance, because any measure of well-being that is highly subjective is going to be hard to use as a policy metric. There is also the fact that both income and measures of happiness are highly correlated with other things that we think of as critical to life quality, like good health and educational attainment, yet causal relationships between all these variables are hard to draw. But there is still something reassuring about subjective well-being studies: If it is true life quality we’re trying to assess, measures of income and of happiness might be on the right track. “As a practical matter,” Wolters says of income and happiness, “they turn out to measure the same thing.”

The Debate over Income Inequality
If policymakers are successful in their efforts to achieve economic growth, they might also care where the income gains go. If the benefits of economic growth are concentrated entirely at the top end of the income distribution, with no income improvements for the rest, we may conclude that the country as a whole has not become much better off.

One way to address income inequality is through outright income redistribution. Proponents of this view argue that a change in either direction of a thousand dollars in income means a great deal to someone earning, say, $20,000 per year while such a change probably means little to a millionaire. Economists refer to this as diminishing marginal utility. It seems to imply that the benefit to the poor of redistributing income could well outweigh the costs to the wealthy.

This is one of the rationales for progressive taxation, but it can be taken too far. For starters, it assumes that it is possible to meaningfully compare utility between people, a proposition most economists eschew. There is also the obvious fact that people work for a reason. Wealthier people, on average, work longer hours, a marked change from generations ago when blue-collar workers usually logged more hours on the job. If the marginal utility of income is truly so low at the top, why would so many wealthy people continue to further their careers and work such taxing hours at the expense of leisure? Is it likely that these people are simply misguided and acting irrationally as behavioral economists might predict?

It is also important to note that some increases in income inequality are not necessarily bad. For instance, Harvard University economist Martin Feldstein argues, along with many neoclassical economists, that policymakers’ decisions should be informed by the “Pareto principle.” This principle, named after the Italian economist Vilfredo Pareto, says that a change is good as long as it makes some people better off and no one else worse off. To illustrate this principle,
Feldstein offers the following thought experiment: A magic bird appears and gives every upper-income American $1,000, increasing income inequality but hurting no one in an absolute sense. Should we begrudge the people who got those $1,000 windfalls? To do so would be to indulge in what Feldstein has called “spiteful egalitarianism.” He argues that analyses which “conclude that all increases in inequality are bad imply...that the social value of incremental income to a rich person is actually negative,” and are inherently misguided.

There is perhaps a better way to address income inequality. We care about income inequality if we think it means that opportunities also are not equal. Promoting equality of opportunity is an important goal of policy though there are obvious differences of opinion about how actively policymakers should equalize opportunity. Some believe equality of opportunity includes providing access to goods such as housing and health care, while others believe it means freedom from excessive taxation or infringement on personal liberties. However you define it, equality of opportunity should be distinguished from promoting equality in outcomes, especially when that equalization jeopardizes incentives for individuals to further invest in skills and education.

**What’s a Policymaker to Do?**

If measures of income are inadequate as a measure of well-being in ways that are well-known, are we on the verge of devising new ways to evaluate quality of life? Probably not.

Anyone who doubts the importance of income for well-being may be less inclined to do so during a recession. Research suggests that a person’s utility can be damaged even more severely by an income decline than it is helped by an income boost. After all, for people who base their happiness on relative income, this could include evaluations not only of how they are doing compared to their neighbors but also of how they themselves are doing now compared to how they did in the past.

Income and GDP may actually be the most all-encompassing measures of well-being we have. They are also highly correlated with many other things that matter, including access to basic necessities, better health, and more education. We can believe income is a good proxy for well-being while recognizing that it requires some qualifiers. “The power of any one number is a myth,” Kenny warns. “Life just isn’t that simple.” But the cause of economic modeling demands concrete, observable ways to measure well-being, and for that task income measures often fit the bill.

At the end of the day, economic analysis is often a basis for policy action. Would re-engineering economic policies to incorporate other measures of well-being change the policies themselves? Yes and no. GDP and its growth are critical, Kenny says. For one, they determine our ability to fund public programs with tax revenues. “Faster economic growth can make a real difference to a lot of pressing policy issues.”

Rather, in his mind, GDP and other measures of well-being are complementary. “It’s not that the emphasis on growth should stop, but taking some of that energy and talent to think about how we get better education and health outcomes — for their own sake, not because they raise income or tax revenues — would be a good thing,” he says.

Wolters believes that many policymakers are far from being staunch technocrats and look at many things besides just income growth. “When I talk to economists we talk about GDP. But I’ve never talked to a politician who said what we should maximize is GDP,” he says. “They intrinsically have a broader sense of a good life and the good society, and democracy forces that on them.”

The right policies can help achieve the type of economic growth that is conducive to a higher standard of living — and the modern world affords opportunities that previous generations could not have even imagined. The role for economists is to illuminate the trade-offs of the policy choices that can help make that possible. Meanwhile, the pursuit of the good life is something individuals will always be engaged in — no matter how anyone defines it.

**Readings**


Everybody in Garrett Park, Md., population 1,000, has business at the town post office because they prefer to pick up mail in person while chatting with neighbors. A possible one-day cut in service, from six to five days a week, says Mayor Chris Keller, has everybody talking. Especially if Saturday gets cut since that’s a big day for commuters to conduct post office business.

The U.S. Postal Service (USPS) says the change, among others, would enable it to weather not only sleet and snow but also recession and a changing mail market. Both have hammered mail streams — especially first-class mail, over which the USPS has a monopoly. It’s the high-octane fuel that subsidizes the cost of carrying mail six days a week to 149 million delivery points from Honolulu to Key West. “With unemployment currently high, mail volumes are unusually low,” says economist Rick Geddes of Cornell University. “It is unlikely that the USPS will be able to further cut costs to avoid losing lots of money.”

Mail volume plunged by 20 billion pieces through third quarter of 2009 over the same period in 2008. The USPS’ net loss: $2.4 billion. To bring in money, the USPS is rolling out initiatives in its competitive shipping business. It’s gained market share in priority mail, and is still delivering plenty of advertising despite the economy. The USPS is consolidating operations and shrinking its work force, albeit incrementally. Still, the USPS will be hard-pressed to stay financially viable, especially in the short run.

Post Office-Opoly

Only the USPS can deliver letter-class mail and other contents to your mailbox, the so-called “mailbox rule.” Standard mail, such as advertising circulars and magazines, is monopolized by the mailbox rule. This forbids private companies from delivering mail without postage to a mailbox.

The USPS has received no taxpayer subsidy since 1982. It gets perks, though. It’s exempt from property or corporate taxes and can borrow money at Treasury rates. The USPS monopoly on letter-class mail and its exclusive access to your mailbox protects its affordable “universal service obligation” to customers everywhere at the same price. Low-cost urban routes subsidize higher-cost rural ones. Yet only about 17 percent of the U.S. population lives in rural areas any longer. Even so, the USPS has in recent years added more than a million rural delivery points.

Historically, the USPS was regarded as a natural monopoly such as transportation or telecommunications. In these industries, extensive delivery networks imply high fixed costs — the bigger the network, the cheaper the costs to provide service on average. A monopoly can achieve these economics of scale more efficiently than having multiple firms duplicate efforts. The USPS has an additional protection in the form of a legal monopoly enforced by the federal government.

Today, many observers have questioned whether postal services should be viewed as a natural monopoly anymore, especially as technology has spurred competition, with positive results, in previously high-fixed-cost industries such as airlines, trucking, natural gas, and telecommunications.

Besides, there are downsides to the restrictions that come with legal monopoly. With mail volume plummeting, the USPS can’t react quickly to the market; that’s why it’s asking permission from the government to cut a delivery day. It must also abide by rules against when a post office can close, not to mention the political uproar when it tries. “The Postal Service faces strong political pressure to leave unneeded mail distribution centers and underutilized post offices open, and to use outdated, labor-intensive technologies,” according to Geddes, in a 2005 paper in the Journal of Economic Perspectives.

Government Accountability Office testimony for a congressional subcommittee in May 2009 emphasized the USPS need to “right size,” but recognized the problem: “USPS has often faced resistance from employees, affected communities, and members of Congress when it has attempted to consolidate its operations and networks.”

Declining Demand

Mail volume peaked at 212 billion pieces in 2006. First-class mail volume fell by almost 5 percent in 2008, and revenues by 0.6 percent despite two price increases. Through the third quarter of 2009, the USPS has seen its biggest consecutive three-quarter decline since 1971. And estimates for 2010 don’t look good either. That means cheaper, standard-class stuff in the mailbox and fewer first-class dollars for the USPS.

Gerald McKiernan, media manager for the USPS, attributes the falloff to...
the sour economy. “A lot of banking correspondence has gone away, a lot of first-class mail; the housing industry mail has gone away.” And, the Internet is taking lucrative first-class mail such as bill payments.

To cope, the USPS wants to defer its obligation to prepay a chunk of its retiree health fund as required by law; last year’s payment was $5.4 billion. Not a trivial expense, given that the USPS has the biggest work force in the nation outside of the U.S. Department of Defense and Wal-Mart.

Second, the Postal Service wants to cut a delivery day, maybe temporarily. A study group at the USPS is meeting with unions, management associations, and consumer groups to see how it would affect their industries, McKiernan says. A curtailed schedule could save $3.5 billion annually, according to the USPS; a George Mason University study for the Postal Regulatory Commission estimated $1.9 billion. As of press time, Congress had not acted on the request to cut a day of delivery, but a committee in the U.S. House of Representatives had approved a partial reduction in payments to the health fund, according to McKiernan.

The USPS’ role and the mail market have changed since the era of the first Postmaster General, Ben Franklin. Back then, the postal service delivered newspapers (for a penny within 100 miles) to far-flung cities and towns to inform the electorate. And pioneers depended on the service as their only conduit for personal letters to friends and family back east.

The postal monopoly was codified in 1845; the mailbox rule dates from 1934. The most recent overhaul to the USPS came in 2006 with the Postal Accountability and Enhancement Act (PAEA). With the act came some flexibility to adjust postal rates. (First-class, standard, periodical, and package service are all monopoly services while express, priority, bulk parcel, and international are competitive.) The PAEA allows annual price changes, but holds average increases for the monopoly mail to the consumer price index. That’s making it hard for the USPS to raise rates right now because inflation is low, McKiernan notes.

Competitive shipping services in 2008 represented about 11 percent of USPS mail revenue and 1 percent of volume. The competition (firms like UPS and FedEx) dominates express and parcel markets, and that includes foreign postal services doing business in the United States. (However, they are feeling the economic strain too. DHL, owned by the German postal service DeutschePost, in 2008 cut its U.S. work force by 14,500 employees and reduced domestic services.)

Lack of innovation is another problem for the regulated monopoly. “We try to do things but we get pulled back,” McKiernan notes. For instance, UPS will pack and ship for a customer, but “we can’t do that.”

But the USPS is discounting and promoting its expedited service like Express and Priority mail for large users, hoping to pick up some DHL business. The USPS also has arranged with shippers to take goods that “last mile,” in some cases, and is piloting a partnership that would enable customers to return UPS-shipped goods via postal carrier. UPS drivers then collect those parcels at the post office.

**Labor and Real Estate**

A local post office is a sacred cow, especially in small towns. Even though the USPS needs to consolidate its real estate, it’s tough. McKiernan notes: “You can’t close a post office for economic reasons only.” He says once when the USPS announced a particular closure, the town’s mayor protested and vowed to send an e-mail about it to the postal service. “There was an irony in that.”

But the USPS desperately needs to reduce capacity and is considering closures. About 413 stations are under review. Already, some 53,196 alternate locations sell stamps, among other services, and the USPS also contracts for service at 4,510 locations. About 1,914 independent firms, like shipping stores, offer USPS services as well as competitor products.

Mayor Keller of Garrett Park says the town’s post office has been targeted for closure at least once, back in the 1950s. “The town undertook a fairly big effort to keep it,” he said. “That was viewed as potentially unfortunate for the community spirit of the town.”

Likewise, it’s hard for the USPS to cut employees, and it is labor — not capital — intensive. Compensation and benefits comprise about 80 percent of USPS costs. And postal workers make about 28 percent more than others in comparable jobs, according to Barry Hirsch, Michael Wachter, and James Gillula, in a 1999 article in *Research in Labor Economics*, updated in 2003. That wage premium rises to 34 percent when occupational skill requirements and working conditions are included, and even more when total benefits are considered.

Even with automation and commercial work-sharing agreements, the percentage of cost attributable to labor has remained the same for some years. Nevertheless, the work force has shrunk through attrition and retirement, from a peak of about 798,000 to 663,000 workers. And more are likely to go — about 160,000 will be eligible to retire in fiscal 2009, and 130,000 more in 2010 through 2013. Some workers also will be offered early retirement.

While labor and operations may be straightforward to quantify, there may be security concerns. For the same reason it’s hard to close a post office, it may be hard to see the mailbox rule relaxed — what if just anyone could use your mailbox?

Pressures about added risks of nuisance mail and identity theft crop up. Residents in Garrett Park, Md., have avoided home delivery for two reasons. Certainly the biggest may be social, “because going to the post office afforded an opportunity to run into people,” Keller says. But should that preference be considered too “touchy-feely,” people also say they like the security of the postal box. They worry about identity theft. While postal customers, by and large, don’t go to that extreme to retrieve mail, identity theft looms as a threat. And the USPS is widely trusted. It came out on top.
in the 2007 and 2008 Ponemon Institute privacy trust rank-
ings of U.S. government agencies. (The nonprofit institute
researches privacy management.)

The USPS’ 1,600 postal inspectors in FY 2008 made
8,919 arrests for various fraud and drug offenses. The USPS
hired the RAND Corp. to analyze effects on the postal
inspection service of changing the mailbox rule. RAND
found that relaxing the rule would add to cost and complex-
ity of the USPS inspection service. However, Jim Campbell,
who consults on postal reform for the European
Commission, says that the issue “has not been significant in
the reforms around the world that are much further down
the road.” In many countries, the incumbent service retains
much of the mail business, even if privatized, corporatized,
or both.

All Around the (Developed) World
Whether relaxing the mailbox rule or the monopoly over
letter-class mail or both would drive the USPS to thrive
would depend on implementation. If the service were priva-
tized, investors would have incentive to make sure it cut
costs and brought in new revenue.

With a continued monopoly, those incentives are dulled.
“If, however, a privatized USPS were also de-monopolized,
and thus subject to competition from other delivery compa-

ties, it need not be subject to price regulation of any kind,”
Geddes says. “In the latter case, its operation would likely be
very efficient and innovative.”

Outside North America, postal markets are opening to
competition, using various approaches. (All except Japan,
says Campbell, which is “getting cold feet.”) The European
Union wants harmonized practices so quality and delivery
among countries stays efficient and transparent.

Reform started with Sweden. In 1994, the Sweden Post
became a state-owned joint stock company, obliged to
provide universal service. By 2007, according to Campbell,
about 90 percent of total mail was delivered by
Sweden Post. Its biggest rival, CityMail, specializes in
delivering presorted bulk mail in cities twice a week.
Sweden Post replaced more than 80 percent of post offices
with contract agencies, to customers’ initial chagrin.
However, customer satisfaction revived as postal services
got better. And service price and quality to urban areas,
where they compete with CityMail, have improved. Sweden
Post has reported 5 percent profit margins in recent years,
according to a 2008 report by Campbell and co-authors

Alex Dieke and Antonia Niederpruem.

Reform is always resisted, says Campbell, who is compil-
ing a survey for the European Commission of postal reform
in the 30 European Union and European Economic Area
countries. “I’ve been involved in postal reform in many parts
of the world. There is no place you can go where they don’t
say, ‘Yes, but this is different.’ But the truth is the postal
office is mainly a buildup of a lot of rather simple operations.
It doesn’t change drastically.”

Yet ongoing European reform often takes one step for-
ward and two steps back. Deutsche Post, for instance, well
on its way to reform, ditched remnants of its monopoly at
the start of 2008, but the German government passed a min-
imum postal wage requirement that has stymied
competition.

The postal service in the Netherlands, TNT, was the first
in Europe to privatize, after combining with an Australian
express package firm. The Dutch government sold its last
stake in the firm in 2006. (As a competitor to Deutsche
Post, TNT is fighting the German labor law.) In the
Netherlands, competition has flourished in the direct-mail
market, and the Dutch government has commissioned TNT
for the universal delivery of correspondence. The EU Postal
Directive requires mail markets to be opened to competi-
tion by the end of 2010; the date is 2013 for 12 of the EU’s 27
states, including Greece, Luxembourg, and Eastern Europe.

Postal networks worldwide will likely continue to re-form
so they can respond to the shifting revenue streams that
drive from a changing mail mix and recession. Delivery
services like FedEx and UPS also have had to manage costs
to offset declines.

The question for the USPS — any postal service —
remains how to manage market conditions when hamstrung
by a monopoly’s accompanying regulations. For now,
the USPS hopes consolidation, its proposed five-day
per week delivery schedule, and relief from prefunding
retiree health benefits will keep the service viable. The
GAO has listed the USPS as “high risk” because of its
infrastructure and personnel costs as mail volume and
revenue decline.

In the long haul, even without a monopoly, the USPS
would more than likely dominate delivery because it would
be tough for competitors to duplicate the network already in
place. Still, Campbell notes, “There is no question that
getting rid of the monopoly pushes the company to do a
better job.”

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Health Care Aisle
Retail medicine pushes competition, price transparency
BY BETTY JOYCE NASH

I stopped by CVS/pharmacy for a tetanus shot, saving my time and my insurance company’s money. The CVS Minute Clinic price list hangs above the computer where I entered personal information and electronically signed the required privacy form. Like many of the clinic’s services, the shot cost $62. This clinic employs nurse practitioners, not doctors, and no receptionists; they are open seven days a week and handle routine and nonurgent medical care.

Medical innovation has channeled routine care into these lower-cost venues as screening and diagnostic devices have gotten smaller and smarter. These retail outlets have created new competition. And it’s having an effect on traditional health care delivery — some doctors have added weekday and Saturday hours.

This niche earned $545 million in revenues last year, according to the market research group Kalorama Information, and may reach $1 billion by 2013. It’s still only a sliver of the market, but there’s no doubt that the clinics are introducing competition.

In-Store Delivery
To survive, clinics must cope with at least some of the same burdens that dog physician practices. After starting as cash-only outlets, they now take health insurance and cope with those administrative costs. Some are Medicare and Medicaid certified, adding another layer of paperwork for the clinic. They also need to turn a profit for the private companies such as CVS that, in some cases, acquired them to attract customers.

Retail clinics have proliferated for almost a decade. They’re about 1,100 strong nationwide and differ from urgent care in that practitioners don’t stitch up wounds or take X-rays, and handle only routine complaints and preventive services.

The rationale behind the clinics isn’t hard to grasp: An estimated 60 percent of patients who show up in the ER have medical needs that don’t require emergency treatment. The clinics can also relieve overbooked primary care doctors, who are in short supply.

The clinics are changing the $2.3 trillion health care industry in small ways. They charge less than a doctor’s office — most services cost between $50 and $75 compared to $55 to $250 at doctors’ offices.

The clinic concept could grow along with consumer-driven health plans with high deductibles. Those comprised 20 percent of health plans in 2008 for the biggest employers, ones with more than 500 workers, according to the global consulting firm Mercer. That percentage rose from 14 percent in 2007. Among “jumbo” firms with more than 20,000 workers, consumer-driven plans are offered by 45 percent of employers.

As benefits grow in cost, for employers and employees alike, people may opt into tax-advantaged health savings accounts with the high-deductible insurance designed for catastrophic illness. Patients would then pay out-of-pocket for routine care, leading to more price awareness. Currently, about 8 million people have such accounts, an increase of about 24 percent over 2008, according to the most recent member survey by the American Health Insurance Corp.

On average, people pay only about 15 percent of the cost of medical care, yet when polled, most say that’s too much, according to health care expert Henry Aaron, a senior fellow at the Brookings Institution. “The real problem is total cost, of which few people are aware.” There’s no incentive to seek out a cheaper tetanus shot if your co-pay will remain the same regardless. But time is money, too, and the clinics are convenient. This may be incentive enough for some health care consumers — even those with lavish insurance coverage — to visit clinics.

Clay Christensen of the Harvard Business School and author of The Innovator’s Prescription notes that the clinics treat problems for which diagnostic and treatment patterns are clear. For example, clinic nurse practitioners identify and treat, when appropriate, strep throat. This “precision medicine” removes judgment from the equation, Christensen says, noting that no retail clinic has been sued for malpractice because practitioners follow the rules. The Minute Clinic, in fact, is accredited by the Joint Commission on Accreditation of Healthcare Organizations, an independent group that certifies hospitals.

The way to improve health care and save money is to drive technology to the point where sophisticated care can be performed in the office or even at home by lower-cost caregivers, according to Christensen. There’s the home blood pressure monitor for a process that formerly was done in an office. Even dialysis machines are now the size of a bread maker, and patients can cleanse blood at home rather than in a hospital or dialysis center.

The clinics make organizational sense, too, according to Regina Herzlinger, also a professor at the Harvard Business School.
School. She calls them a type of “focused factory” that specializes in low-acuity care. That makes them more efficient. “They are chains, many use nurse practitioners rather than M.D.s, and they use IT to ensure that their care protocols are followed,” she says.

The retail clinics were first to post prices. That helps close the gap in knowledge between consumers and professionals about price and quality.

“The retail clinics are a little ahead of the game in terms of transparency,” says Tom Charland, chief executive of Merchant Medicine. The group tracks retail health clinics and consults with physicians. Higher-deductible health plans might drive patients to the clinics and encourage transparency. “If you’re paying for the first $5,000 of health care, you will start to understand the explanation of benefits and coding,” he notes. People can’t decipher health care invoices now “because the transaction is between the doctor and the insurance company and not you.”

Also, the convenience of the retail setting may have improved access for underserved populations, according to Hertzlinger. Forty percent of clinic patients are nonwhite compared to 18 percent of nonusers of retail clinics. And 28 percent have annual household income of less than $40,000 versus 16 percent for nonusers. Further, 12 percent of the users are uninsured compared to 6 percent of nonusers. Walgreens, owner of Take Care retail clinics, is even offering free illness/injury care to anyone without health insurance who lost a job on or after March 31, through the end of 2009. (Walgreens operates no clinics in the District.)

State and national medical groups have expressed concern that clinics may further fragment care, and have published standards that ensure continuity of care with practicing physicians. But many clinic patients have no primary care physician — 28 percent of clinic users compared to 15 percent for nonusers, according to the Deloitte Center for Health Solutions.

It’s Not Contagious

Despite the convenience, by 2007 only about 2.3 percent of American families (around 3.4 million) had ever used a retail clinic, according to a Health Tracking Household Survey conducted by the Center for Studying Health System Change.

Another study by the nonprofit RAND Corporation indicates that clinics “appear to attract patients who are not routine users of the current health care system.” Ateev Mehrota, a professor at the University of Pittsburgh School of Medicine and a RAND researcher, studied retail clinics for seven years, between 2000 and 2007. Mehrota and his colleagues analyzed 1.3 million visits to various locations of eight retail clinic operators. They found that 43 percent of patients were 18 to 44 years old — the biggest category of the uninsured — compared to 23 percent for primary care offices. In this study, 39 percent of retail clinic patients said they had a primary care physician, compared to 80 percent of people surveyed nationally.

Over the study period, the payment method changed from 100 percent out-of-pocket in 2000 to 16 percent in 2007. Ninety percent of clinic visits were for the following: upper respiratory infections, sinusitis, bronchitis, sore throat, immunizations, inner ear infections, swimmer’s ear, conjunctivitis, urinary tract infections, and screenings or blood tests. Those same conditions accounted for 18 percent of visits to primary care doctors’ offices and 12 percent of emergency department visits.

Retail clinics refer people to a primary care physician if they don’t have one, and many don’t, says nurse practitioner and manager of the Virginia Minute Clinics, Anne Pohnert. She directs patients with emergencies to the local ER, as she recently did for a construction worker with a trauma. And while the clinics offer diabetes screening, they don’t treat this chronic condition. Likewise, if a nurse detected a heart irregularity during a routine physical, the patient would be sent to a doctor.

The CVS clinic where I got my tetanus shot is in a new store, and fills about 120 square feet; there are two tiny examining rooms for privacy. Weekends, Pohnert says, are particularly busy; but when I arrived at noon on a weekday in May, I was the only patient. The busiest time is flu season.

And the off-season has led to the biggest business challenge for retail health clinics. “They are scrambling to find services that have the same impact of strep throat and ear infection cases and those sorts of things,” Charland says. “There isn’t an equivalent thing that happens in the summer unless you move into the world of injury.” There have been 89 temporary closings in 2009 for the Minute Clinic chain.

CVS operates Minute Clinics in 454 stores nationwide and 73 clinics in Maryland, Virginia, and the Carolinas. Another retail health provider, RediClinic, pulled out of Wal-Mart in Richmond in 2008 because the clinic was “underperforming,” according to a RediClinic spokeswoman.

Today, clinics are located inside drug stores (CVS, Walgreens, Rite-Aid); grocery stores (Kroger, Publix, Cub Foods, ShopKo); or mass merchandise stores (Wal-Mart, Target). Some clinics partner with hospitals, especially for the advantage that comes from physician oversight. Hospitals, like stores, may benefit from the affiliation because the clinic may attract customers.

But it’s not only for-profits that are sending care closer to the consumer for convenience and availability. Valley Health, a nonprofit owner of five hospitals in Virginia and West Virginia, operates separate outpatient services including two “Quick Care” clinics. The first Quick Care opened in a strip-mall storefront in 2007 to handle common minor ailments. Valley Health opened another Quick Care earlier this year. Clinics operate from 7 a.m. until 7 p.m. on weekdays and from 9 a.m. until 5 p.m. on weekends.

“We know that if all those patients had streamed to our emergency department, the doors would have burst off a long time ago,” says director of marketing and public relations Tom Urtz. He notes revenues from the Quick Care
that opened in 2007 rose by 5 percent in 2008.

The clinics have influenced local health care delivery. “We were a leader in getting nonurgent care service available on weekends and evenings, and a number of physicians have gone into that same space following us,” Urtz says.

Geisinger Health System in Pennsylvania opened its first CareWorks clinic in 2006, through its Geisinger Ventures for-profit group. Now five clinics operate inside high-traffic Weis grocery stores, a regional chain. More than one-third of patients are uninsured. The Geisinger system also includes hospitals, community clinics, a health research center, and a nonprofit health insurance company. It integrates the retail clinics with its electronic records — lab results, for instance, can be accessed securely online — so the patients’ medical records stay up-to-date. The firm hopes to “broaden the reach” of the clinics outside of Pennsylvania, according to Geisinger’s national media director Patricia Urosevich. “We would look for a partner to do that.”

Sustaining Services

Early on, there were regulatory and even legal challenges to the clinics, many of which addressed the role of the M.D. who oversees clinic practitioners. Mike Edwards, spokesman for the North Carolina Medical Society, says society standards limit the scope of service and specify oversight arrangements to make sure “patients know in advance what they’re getting and what they’re not getting.”

When RediClinic operated its Wal-Mart-based clinic, the company partnered with Bon Secours Richmond Health System in Virginia. Spokeswoman Kim Brundage explains how the partnership worked: “Our physicians would review the charts and the questions the nurse practitioners had,” she says. And they would be on-site for limited amounts of time.

Doctors still worry that the clinics will miss something. Questions have also been raised about the potential lack of continuity of care: “When care is fragmented, with different clinics or clinicians providing care at different times, trends suggestive of serious underlying conditions may be missed, and if clinics have no explicit after-hours arrangements, complications arising from daytime care may go unaddressed,” writes Richard Bohmer in a New England Journal of Medicine article.

But the clinics are auxiliary services, says Urosevich of Geisinger. “The model isn’t that you retain the patient; the model is you follow up with the patient’s regular physician,” she says. “It turns out to be a pleaser, in most cases.”

While the clinics have touched a nerve among medical professionals, they’ve also tapped a niche that can serve the uninsured, especially young people. And with many in entry-level, low-wage, or temporary jobs that don’t offer health insurance, it’s not so surprising that 29 percent of the uninsured are between age 19 and 29, according to the Kaiser Family Foundation.

When Pohnert senses a problem, like the 28-year-old otherwise healthy man with high blood pressure who drinks six caffeinated sodas a day, she recommends a primary care physician. “We always have a list of PCPs who are taking new patients.”

On the regulatory front, Minute Clinic senior legal counsel Sara Ratner says the fuss has abated. In Illinois, for instance, legislators in 2008 tried to impose a lengthy permitting and licensing regime. The Federal Trade Commission, in response to a legislator’s request, issued a statement that warned against anticompetitive laws. “Now that we’re almost a decade into the retail clinic concept, people are more comfortable with it,” Ratner says. “The tendency to overregulate has gone away.” The variety of state regulations may play some role in clinic location. Experts suggest market demand, population density, and primary care physician shortages play a larger role than regulation in clinic location. For instance, state penetration is highest in Florida even though that state limits nurse practitioner autonomy more than most.

Going forward, the trend to watch is represented by a pact between Minute Clinic and the Cleveland Clinic in Northeast Ohio. The medical center will consult with Minute Clinics’ nurse practitioners; the two systems also will integrate electronic medical records.

“In this partnership we might well see disease management,” Charland says. That could expand the clinics’ scope. They could, for example, handle routine tasks for patients with chronic disease, such as diabetics. That would alleviate post-season lull in business. “I think we would see these clinics open up all over the place if they could solve the seasonality issue.”

Acceptance will take time. Nationwide, retail clinic growth has slowed, with seven clinics opening in April compared to 15 during the same month in 2008, according to Merchant Medicine. And Wal-Mart has said it will not meet its 2007 target of 400 in-store clinics in two to three years.

WSL Strategic Retail president Candace Corlett has included the retail health clinics in consumer surveys for the 

continued on page 27
The debate over the role of government as referee of market competition

BY DAVID VAN DEN BERG AND STEPHEN SLIVINSKI

On May 12, 2009, Christine Varney, the assistant attorney general of the Department of Justice’s antitrust division, made a speech to the U.S. Chamber of Commerce. She declared a renewed interest by the federal government in pursuing more aggressive action against companies with substantial market power. “As antitrust enforcers, we cannot sit on the sidelines any longer — both in terms of enforcing the antitrust laws and contributing to sound competition policy as part of our nation’s economic strategy.”

Varney, known for her career as a prominent Washington attorney and member of the Federal Trade Commission (FTC) between 1994 and 1997, was referring to what she saw as a neglect of the government’s role in policing some types of corporate business activity. The last time the federal government actively pursued a number of high-profile antitrust cases was in the 1990s. That period, however, was a temporary change from the long-term decline in the number of government-launched antitrust cases — a trend that started as early as the 1970s.

The policy debate now hinges on assumptions about whether the modern market economy is especially prone to harming consumers or whether markets are vibrant enough to punish firms that try to engage in anticompetitive behavior. In other words, whether the government should play an active role as a referee of competition in the marketplace.

Economists and legal scholars have pondered these issues for decades. While there is wide agreement that cartels reduce consumer welfare and should be dismantled, they have proven hard to maintain in a modern developed economy with low barriers to entry. Today, disagreement instead exists over the ability of individual firms to act in a near-monopolistic fashion. Whatever consensus has formed on that issue, however, suggests that government might have only a limited ability to improve on market outcomes.

The Evolution of Antitrust

The first U.S. antitrust statute was the Sherman Act of 1890. It outlawed cartelization of industries — or, in the words of the law, any “conspiracy” among multiple companies that would result “in restraint of trade” — and monopolization. The law didn’t really provide a working definition for either of these concepts. It is, however, the statute that gives the power, in Section 2, to the government to pursue legal action against a single firm acting as if it were a monopoly. (Modern-day antitrust actions tend to be Section 2 prosecutions.)

In 1914, Congress passed the Clayton Act and it served to clarify the Sherman Act. It went so far as to prohibit specific actions that were seen as anticompetitive, like mergers that “substantially lessen competition.” The same year saw the passage of the Federal Trade Commission Act that created an executive branch agency able to launch investigations and issue cease and desist orders to corporations engaged in what were considered unfair trade practices. It also created a system by which private firms could lodge complaints against their competitors and, if the FTC deems it appropriate, trigger investigations of those against which complaints were filed. After 1914, only a few other laws have honed the scope of government action and the tools it can use to police competition in the marketplace.

Yet, while policymakers and judges pondered what qualified as competition-squelching business activity, economists were largely silent in the policy debate for the next 30 years. While most scorned the Sherman Act and its subsequent modifications, that’s usually as far as they went. “At best, the statute seemed a harmless measure incapable of halting an irresistible trend toward firms of larger scale and scope,” write George Washington University law professor William Kovacic and University of California, Berkeley economist Carl Shapiro in the "Journal of Economic Perspectives.”

An era of aggressive governmental action against businesses, particularly in the realm of corporate mergers, began in the mid-1930s. A number of major antitrust decisions breaking up companies and hindering mergers handed down by the Supreme Court and lower courts continued generally unabated until the 1970s. The lopsided nature of the case law that emerged from this period even spurred Supreme Court Justice Potter Stewart to describe the era’s merger decisions in a 1966 opinion by a simple formulation: “The government always wins.”

By the early 1970s, economists and legal scholars based largely at the University of Chicago — among them current federal judge Richard Posner, former judge Robert Bork, and economist George Stigler — began to counter the level of activism present in court rulings. “The Chicago School approach used the tools of microeconomics to explain business arrangements with an eye toward carefully understanding the markets and institutions within which the arrangements were generated,” says George Mason University law professor Joshua Wright.

This was a contrast from the legal consensus at the time that applied the notion of “per se illegality” in antitrust cases. This meant that certain business practices were by definition a violation of the law regardless of the justification for the arrangement or its effect on consumers. As Bork described it his seminal book on the Chicago approach,
The Antitrust Paradox, published in 1978: “Behavior is illegal per se when the plaintiff need prove only that it occurred in order to win his case, there being no other elements to the offense and no allowable defense.” A good example — and one that would still be prosecuted today on this same basis — is the behavior engaged in by members of a cartel.

In most cases, the Chicago School critics argued that a better standard was one that eventually became known as the “rule of reason” — a real-world assessment in which market realities and corporate structures are to be viewed in light of actual outcomes. Bork describes this as being “judged by the standards of the party’s intent or the effect his behavior was likely to have, considering the market context.”

An example would be a large firm that has high fixed costs but passes along lower prices to consumers if they are able to spread the costs over a larger base of customers. When judgments based on per se illegality were the norm, the mere fact that this firm is so large and dominated such a large share of the customer base might be enough to spark a legal rebuke and a stiff penalty.

The Chicago School analysts would point out that a large firm’s presence might actually make consumers better off relative to its absence. That consideration, they argued, should be the focus of antitrust analysis. Indeed, Bork suggested that the “only legitimate goal of antitrust is the maximization of consumer welfare.”

A related concern was whether increased action by government to punish firms for what was perceived as anticompetitive behavior might stifle market innovation. In such a scenario, new business arrangements that merely ran the risk of running afoul of an ill-defined legal standard might never see the light of day and consequently make consumers worse off in the aggregate.

The Chicago approach gained prominence just as economists started to take a greater role in antitrust jurisprudence. Involvement of economists in the practice of antitrust law reached its current peak in the 1980s and 1990s when economists — particularly those with a Chicago School bent — were appointed to prominent positions with the FTC.

Today the broad consensus in antitrust law has been defined by economists or legal scholars with substantial economics training. “Most commentators, even those who are now critical of the Chicago School contribution to antitrust economics, agree that the Chicago School dramatically improved the state of affairs,” says Wright.

A Question of Market Power

The thinking in modern antitrust circles that supports a more activist role for government goes like this: A firm doesn’t need to be the only provider of a good to damage competition — it merely needs to be the dominant firm in that market and act as if it was a monopoly by exercising its “market power.” That could potentially result in behavior that reduces consumer welfare and drives out competition.

Straightforward as this may seem, it’s often a difficult situation to identify in practice. “Monopolization is the most vexing problem for antitrust lawyers precisely because it is so difficult to confidently and accurately identify and distinguish conduct that will help consumers from conduct that might harm them,” says Wright.

To prove a firm’s dominant power, the first task is to define the scope of the relevant market, both geographically and in terms of which products are considered substitutes within that defined market. Then the general rule is to determine whether a company could increase the price of its product by 5 percent without losing profit. According to standard antitrust legal definitions, being able to do so would indicate the existence of a firm with monopoly-like power.

But defining the relevant size of the market is tricky and fraught with peril. “There’s a tendency for the Department of Justice and the Federal Trade Commission to push for definitions of the market that in hindsight look to be inappropriately narrow,” says William Shughart, a professor of economics at the University of Mississippi who served as an economist at the FTC from 1979 to 1983.

A recent example is the debate in 2007 around the merger of the supermarket chains Whole Foods and Wild Oats, both of which specialized in selling organic produce and food products. The FTC challenged the merger on the grounds that it would create a firm that was much too dominant in its relevant market. But Shughart notes that the FTC was defining the relevant market as existing mainly of the two specialty chains in question. “The market is probably much wider than that and might include all grocery stores, many of whom at the time
were beginning to introduce sections devoted to carrying organic consumer products.”

Coming up with an answer to the question of how to define the scope of a market also suffers from a potentially insurmountable information problem. “Rarely in an antitrust case do the economists on either side have all the data that they would like to have to help them develop a sound market definition,” says Shughart.

In the meantime, as the economy becomes more complex and barriers to competition fall, economists note it becomes difficult to make the case that most firms can maintain any sort of monopoly pricing power they might have for very long. The market can provide a check on behavior that might be anticompetitive or harm consumers. The risk of rival firms entering the market and offering lower prices or better service and products could be enough to discipline the incumbent firm if the barriers to entry in a market are low enough.

Fit to be Tied?
Another business practice that antitrust enforcers look to as evidence of anticompetitive behavior are “tying” or “bundling” arrangements. That’s when a company makes the purchase of one of its products conditional on the purchase of another. Tying is seen by some antitrust scholars as reducing consumer welfare because it inhibits competition in related goods. Such was the basis of the Justice Department’s case against Microsoft in the late 1990s. The Department of Justice and the FTC alleged that the company had monopoly power over certain types of personal computing platforms because it required the purchase and installation of its Internet browser on any computer that also ran Windows, its operating system.

Yet the existence of bundles is more prevalent than many people realize. In fact, it’s quite plausible they are so prevalent for a good reason. To explain this reality, the Chicago School critics of antitrust have long sought to inject into the discussion of antitrust analysis a real-world understanding of the corporate arrangements and pricing structures that allow new products to be brought to market.

One reason tying arrangements might persist is that they enhance the ability of companies to create new markets through the cross-subsidization of two products. Usually this occurs when a good with high costs to produce is paired with another good that is relatively cheap to produce. Prohibiting a tying arrangement — or a flat price for selling the two goods bundled together — might result in a decline in consumer welfare. The cross-subsidy might, at least in the short term, be the only way for the firm to efficiently provide the product.

Pondering whether a tying arrangement might be a drag on competition, however, can become a “metaphysical” task, writes Bork. “Every person who sells anything imposes a tying arrangement. This is true because every product or service could be broken down into smaller components capable of being sold separately, and every seller either refuses at some point to break the product down any further or, what comes to the same thing, charges a proportionally higher price for the smaller unit.”

Bork uses the examples of a car dealer who refuses to sell a customer only the automobile chassis or a grocer who sells the pears and the can they are stored in together for one price. Giving the courts broad latitude to determine whether one product or two is being sold would put judges in the position of “determining an efficient way to run a business, a subject in which they have little expertise,” he writes.

Incidentally, Robert Bork shocked many of his colleagues and admirers when he favored the government’s action against Microsoft in 1998. By his reasoning, those tying agreements were enough to squelch competition in the browser market. It was a controversial argument at the time, not least because it seemed to contradict his earlier writings on the subject. Many noted that rival browsers already existed and could compete with Microsoft’s product. Today, in a world where browser competition is lively and technological innovation is rapid, it may seem quaint to think that a single company would be able to dominate for long — or that a judge would be able to accurately predict the future course of the market, the optimal arrangement of firms within a specific industry, or the rationality of a business decision.

Costly Errors and Political Influence
In antitrust enforcement, like any area of life, errors can and do occur. When antitrust enforcers make mistakes, those errors could be quite costly to the economy and to consumer welfare.

There are two types of errors to consider. False positives occur when judges mistakenly impose penalties on firms that are engaged in practices which don’t actually constitute anticompetitive behavior. False negatives occur when actual anticompetitive practices are not punished.

As Wright points out, “it is well accepted that false positives are more costly than false negatives.” That’s because mistakenly punishing a firm also eliminates the contribution it was making to consumer welfare. When decisions handed down by a court can include measures as extreme as ordering the breakup of a company perceived to be acting as a monopolist, you can see how consumers would be worse off if you assume that the composition of existing firms is rational in an economic sense. The redistribution of the market shares would lead to an economic loss.

Conversely, as Northwestern University law professor Fred McChesney writes in a 2003 issue of the Emory Law Journal, false negatives will have a less severe long-term impact so long as entry barriers into markets are low. “As prices rise because of anticompetitive contracts or practices, new entrants emerge to alleviate or even eradicate the problem,” he notes. The error of inaction on the part of courts is actually “a self-correcting problem,” McChesney writes.
The question then becomes whether the antitrust system is more prone to the costly type of errors. And some economists view antitrust enforcement as not just error-prone — they see it as the product of a system that can also be gamed, thereby increasing the odds that costly errors occur. “There is a great deal of political influence on the process which is instigated by competitors of the firms that have a big stake in the outcome,” says Shughart.

Recall that individual firms can lodge complaints against their business rivals through the FTC, and this opens up the door to using the government as a tool to beat up on their competition. “Antitrust enforcers must be very skeptical of claims brought by competitors against one another and do a much more thorough investigation in those cases than they might otherwise do to rule out the possibility the initial complaint was just self-serving,” notes Shughart.

He also points out that there is substantial evidence to show that competitors of defendant companies in antitrust cases are the main beneficiaries. This “abuse of antitrust,” as New York University economics professors William Baumol and Janusz Ordover characterized it in the *Journal of Law & Economics*, comes with costs that might well exceed any pro-competitive benefits of antitrust law.

This concern has its roots in the Chicago School critique as well. George Stigler made the case that regulatory agencies — especially those vested with the power to punish companies — risk being “captured” by the businesses they are supposed to regulate. When government has the power to determine when there are too few firms in an industry, every firm in the industry will vie to influence the decisions of the regulatory body and attempt to use regulation for private rather than public benefit.

**The Future of Antitrust**

What used to be known as the Chicago approach might now be more aptly described as the modern consensus. Daniel Crane, a law professor at the University of Michigan Law School, has noted that, at least for the time being, nonintervention is the default assumption among antitrust judges.

There are criticisms to this consensus from a new breed of legal scholars and some economists. These “post-Chicago” scholars, while acknowledging the importance of the neoclassical model for developing coherence in antitrust policy, have launched critiques of some of the assumptions of the consensus. The result is advocacy of a more activist approach to antitrust and making the case for when more extensive government intervention may be justified.

One key difference between the Chicago School and its critics is the concern that the market won’t react quickly enough to discipline dominant firms. “Competition is a public good,” argues Jonathan Baker, an American University law professor and former head of the FTC’s Bureau of Economics from 1995 to 1998, in a 2003 article in the *Journal of Economic Perspectives*. Over the long term, rival firms may arise to compete with the dominant firm. But it won’t happen quickly and in the interim the costs to consumers will be too high.

Nevertheless, judicial and academic consensuses are hard to dislodge in the short term. Any activist enforcement of antitrust statutes will likely meet resistance from a judiciary steeped in the Chicago approach.

Besides, antitrust cases take a long time to prepare, Shughart says. That means it may take years before a government case sees the light of day. Yet, many years is a lifetime in a rapidly changing and innovative economy, notes Shughart, “and what the market looks like after the case is brought will be completely different from what it looked like when they started.” Any company that seems to have dominant market share today may not have such market power years later — or, for that matter, exist at all.

So the most significant problem for a more activist antitrust enforcement may not come from any particular academic discipline or school of thought. Instead, it may come from the simple reality of a fast-changing modern economy — characterized by technological advancement and generally lower barriers to entry.

**Readings**


Few firms can escape changes in the business cycle. The general characteristics of economic booms are increases in employment and income. During recessions, unemployment rises instead.

Yet not all companies or industries will feel effects of the same magnitude when the economy stalls. Take, for instance, beach towns. Myrtle Beach, S.C., is a tourism hotspot where demand fluctuates widely depending on the weather. But unlike many other areas, it’s not home to a diverse set of industries. There aren’t a lot of corporate jobs in the Myrtle Beach area, says Pauline Levesque, former president and chief executive officer of the Myrtle Beach Area Hospitality Association. About a third of all jobs in the region are either in hotels or restaurants.

Thus, seasonal income and employment are a fundamental characteristic of the region, which usually faces fairly predictable seasonal cycles. However, this summer the area was clobbered by an unexpectedly severe business downturn too. “We’ve gone through other recessions, certainly, but haven’t seen retail spending be off by as much as it has, haven’t seen hotels having to discount as steeply as they are just to fight for any kind of market share this summer,” says Don Schunk, an economist at Coastal Carolina University in Conway, S.C., near Myrtle Beach.

Developments in Myrtle Beach this year, where declining consumer spending lowered demand for seasonal employment, help illustrate how business cycles and seasonal cycles are related.

**Supply and Demand**

Research on seasonality tends to focus on data adjustments, as opposed to the nature of seasonal cycles themselves. To the extent economists have studied seasonal employment it’s largely been in relation to how the fluctuations should be smoothed through the ebbs and flows of the business cycle.

Tourism labor, whether seasonal or permanent, is difficult to track. That’s because governments gather statistics by industry code and there is no code for tourism, says Richard Perdue, chair of the hospitality and tourism management department at Virginia Tech. Instead, all types of tourism are grouped under the “leisure and hospitality” heading, which also includes things like sports and restaurants. Perdue also notes that many of the products and services that tourists buy and use are also purchased by the year-round residents of destination communities. So, in many tourist towns, businesses that play a key role in supporting visitors, like grocery stores, are important for locals as well.

Yet business cycle trends cannot be ignored in an area where tourism dominates the economy. Myrtle Beach sits at the heart of the Grand Strand, a 60-mile stretch of beachfront from the North and South Carolina border past the city. The region attracts about 14 million visitors a year, many of whom drive there.

In each month this year — except for May when motorcycle rally crowds largely stayed away after the city of Myrtle Beach tightened noise and helmet ordinances hoping to drive out the events — the area has welcomed about the same number of tourists as it did in 2008. However, they’re not staying as long and not spending as much.

This has caused a significant drop in consumer spending in the area. From January through April, that spending declined 16 percent. It’s expected to drop 12 percent for the peak season in 2009 compared to the same period in 2008, Schunk says. “In a tourist destination it all comes down to consumer spending,” he notes. “One of the major implications might not be revealed until the fall. I think we could be looking at some pretty steep declines, even steeper than usual declines, in terms of seasonal employment.”

Destinations like Myrtle Beach are likely to have far more seasonal employment fluctuations in tourism-related businesses than cities like Washington, D.C., where the culture and historic monuments drive year-round tourism, says Perdue. So tourism properties work to build traffic during “shoulder seasons” on either side of their peak period.

**Jobs Wash Away**

This year proved challenging for lodging properties in the Myrtle Beach area, which cut rates to lure more visitors. For instance, Myrtle Beach Seaside Resorts dropped its rates 20 percent, says Jim Eggen, the company’s general manager. Oceana Resorts President and Chief Executive Officer Frans Mustert says his company, which has nine properties, has dropped rates by as much as 30 percent from last year.

This year, the Myrtle Beach region saw a small decline in the number of seasonal jobs available. While seasonal hiring usually ramps up in the spring, and while some jobs were added during that time, Schunk says those gains weren’t as large as normal.

Usually, local businesses hire seasonal workers for the peak spring and summer seasons in March to allow time to have all those staffers trained. The motorcycle rally crowds typically boosted hotel occupancy to about 75 percent in May, and without that traffic this year, many hotels and restaurants held off on adding workers, says Taylor Damonte, director of the center for resort tourism at Coastal Carolina University. In June, he said many businesses were staffed for 40 percent to 50 percent.
occasional occupancy. “It’s happening later for the industry in general this year, that staffing up,” he says.

Of course, spikes in unemployment typically occur in recessions. Nationally, the rate of increase of the unemployment rate this recession resembles the 1973-75 and 1981-82 downturns, Beth Mowry and Murat Tasci of the Federal Reserve Bank of Cleveland write in a recent article. Unemployment has nearly doubled in Myrtle Beach’s Horry County in the past year, and in August was 10.5 percent, expanding candidate pools for many companies.

In March, the Myrtle Beach Area Hospitality Association held a job fair for employers in any industry. More than 8,000 job seekers attended, while only 38 vendors were present, according to Levesque. In 2008, 6,000 job seekers and 140 vendors attended the fair. “I think that their staffing strategy is just to keep the numbers low and manage from there,” Levesque says.

While there were fewer jobs, the pool of candidates seeking them was larger and more diverse. That allowed Myrtle Beach Seaside Resorts, which has nine properties in the region, to find workers it may not have been able to otherwise, Eggen says. “I’m getting some people who were general managers and executives in different positions looking for work,” he says. “Quite a few of our folks have four-year degrees working at the front desk.”

Recovery may not come quickly for tourist towns like Myrtle Beach once the bulk of the current economic storm passes. Travelers have changed their price expectations and may no longer be accustomed to booking their vacation so far in advance. “I think we’ll have to change how we do business,” Eggen says. “You give someone a great deal; they don’t think it’s a great deal. They think it’s now the new standard.”

Just as consumers may not change their behavior, employers may not generally boost their staffs quickly either. “I think the severity and length of this recession exceed the experience of most tourism business managers, leading me to suggest the recovery may be slower as managers hesitate to add payroll obligations,” Perdue argues.

Readings


Readings


Why are some societies relatively rich and others relatively poor? This is perhaps the most fundamental question in all of economics. Although aspects of the issue remain unresolved, there is a consensus among economists that well-defined property rights, low and stable inflation, and reasonable regulatory and taxation regimes are conducive to growth. In short, markets do produce the goods.

But what produces the institutions that are necessary for the development of a well-functioning market system? That is the question that economist Timur Kuran of Duke University has been asking recently. In particular, his work has led him to wonder why the Middle East, probably the most prosperous region of the world in the Middle Ages, failed to grow in the way that Western Europe has during the last several centuries. The product of that research will appear in 2010 with the publication of his book *Islam and Economic Underdevelopment: Legal Roots of Organizational Stagnation in the Middle East*.

Kuran has been interested in the economics of religion for many years, but much of his early work was on a very different topic: What are the incentives that lead people often to express a certain preference privately but another publicly — and what are the public policy implications of such “preference falsification”?

Before coming to Duke in 2007, Kuran taught at the University of Southern California for 25 years. He also has held visiting positions at the University of Chicago and Stanford University.

Aaron Steelman interviewed Kuran in his office at Duke on Sept. 16, 2009.

RF: Could you briefly discuss what you mean by the phrase “preference falsification”?

*Kuran:* Preference falsification is the act of wanting one thing and saying that you want another, or having one ranking among options but conveying another publicly. It happens frequently in every society. Just to be polite, for instance, we may express admiration for something we don’t really admire. Preference falsification also occurs in response to perceived social pressures. We perceive that if we don’t express admiration for something or, alternatively, we don’t condemn something, we ourselves will be condemned or else miss out on a particular reward. The motivating perception need not correspond to reality. Finding ourselves in a group of people looking at a painting, we may sense that the group considers it beautiful, perhaps because the painting is famous, when actually everyone thinks it is pretty mediocre. So we wind up praising the painting because this appears to be a safe course of action. In such contexts preference falsification does not do much harm. If we always said what popped into our minds, there would be more frictions, and more hurt. White lies serve a useful purpose.

However, preference falsification is common also in situations where it does measurable harm. When a community is trying to decide how to govern itself or which economic policies to pursue, untruthfulness distorts the political system. It sends signals that make others reluctant to express themselves truthfully.
Kuran: I certainly agree. Chinese economic liberalization is producing a prosperous middle class. At present this middle class is putting up with social controls because it is getting richer at a very rapid pace. Sooner or later it will want to share political power.
In a modern democracy, we elect candidates by a secret ballot. This is partly because we recognize that preference falsification distorts the choices we make collectively. The secret ballot allows voters to express choices without risking retaliation. Yet, the voters who go to the polls do not face a full menu of options. Typically, their options have been truncated by a political struggle that ran its course well before the polls opened. Candidates have been selected in an environment in which money matters enormously, and those able to raise sufficient money are the candidates who have said nothing offensive to the perceived mainstream. The upshot is that on most issues candidates take positions fairly close to the middle of the ideological spectrum. This is not to deny that political parties can differ on particular issues. However, the process that I have described does weed out individuals with ideas that are perhaps premature or perceived as risky. Such individuals never come before us as serious candidates. Consequently, on almost any issue one can identify positions that ought to receive political consideration but do not.

Let me illustrate this claim through an example. As everyone knows, a large share of our health care resources goes to terminally ill people. Meanwhile, millions of young and middle-aged people lack health insurance. Obviously, many of the people in the latter group would benefit from insurance. Hence, society should be discussing the merits of rationing health care subsidies to the very old in the interest of providing better health care to the young and middle-aged. Yet, few individual leaders are willing to do so openly and honestly. It is extremely risky even to mention the existence of a trade-off.

Judge Richard Posner might be mentioned as an exception. I do not know whether he has written specifically about the trade-off in question. However, on a number of other issues he has taken quite radical positions that other circuit court judges are not willing to take. Perhaps the reason is that he is unlikely to be nominated to the Supreme Court. If so, he has little to lose by stating his preferences truthfully and much to gain from solidifying his reputation within the legal profession as someone prepared to voice his opinions fervently. A younger circuit court judge, or a law professor eyeing a Supreme Court nomination, has everything to lose from taking positions perceived as radical.

RF: How did you become interested in the economics of religion?

Kuran: I grew up in Turkey, which is a predominantly Muslim country with a secular constitution. At the time, educated Turks were overwhelmingly supportive of secularism. They agreed that the abrogation of Islamic law was justified and approved of making westernization an official policy. Yet no one talked about the disadvantages of the discarded Islamic institutions. Implicit in all discussions was the idea that these institutions were harmful; they resulted in backwardness, they delayed Turkey’s industrialization, they kept the literacy rate low, and so on. I never understood the mechanisms involved because the claims were not publicly debated.

I came to the United States for college and got interested in economics. At the time, economists showed no interest in religion. Religion was one thing and economics another; neither had anything to contribute to the other. As a Ph.D. student in economics, I did not do any work that touched on religion. However, I thought that one day I would explore this topic.

When I completed my dissertation in March 1982, I already had a job lined up for September. I decided to give myself one month to read works I would probably not read as an assistant professor trying to publish in conventional subfields of the discipline. This was my reward for graduating early. Wandering through Stanford’s Green Library in search of interesting books, I came across such titles as Islam and Economics and Islam and Development. These were books written by “Islamic economists.” They claimed that the world’s economic problems could be solved by returning to Islam. The arguments appeared interesting yet superficial. I shared my criticisms with some friends, who encouraged me to turn them into an article.

Before my move to the University of Southern California that fall, I had drafted a critique of this literature. The Journal of Economic Behavior & Organization published the piece in 1983, following two rounds of revisions. Soon after publication I started getting calls. Islamist movements were
making waves and people wanted to know the implications for economics. On account of one journal article, I wound up being invited to conferences and seminars as an expert. I denied being an expert; all I had done was to read some books and write a critique. But apparently I belonged to a tiny group of formally trained economists who had studied Islamic economics with an open mind and objectively. Before I knew it, I was writing other articles on the subject. My research began to encompass Islamic economic reforms that were taking place in countries like Pakistan and Malaysia. The book Islam and Mammon collects some of my major findings and arguments.

**RF:** Is there such a thing as “Islamic economics,” or is it, as some have claimed, an invented tradition?

**Kuran:** Although the concept of “Islamic economics” dates from the 1940s, it is promoted as a very old doctrine that gave rise to many practical successes. In that sense it is indeed an invented tradition. Today, Islamic economics constitutes a vibrant school of thought. It is the subject of international conferences at which various issues are debated. In terms of analytic sophistication it does not rise to the level of neoclassical economics or even Marxist economics. The rather repetitive literature that falls under the rubric of Islamic economics promotes certain principles, and it revolves around certain pet issues. Over the years, I should add, its sophistication has grown. There now exist quarterly journals of Islamic economics that have the feel of the American Economic Review, at least in the sense that they are filled with models and statistical tests.

If you are asking whether Islam offers a distinct form of economics, my answer is no. The economic principles spelled out in the Koran closely resemble ones found in the Bible. The Koran encourages transparency in economic relations. It promotes honesty. It requires people to be charitable toward others. Such prescriptions are not unique to Islam, or, for that matter, to religion.

**RF:** What, then, are the principles of “Islamic economics,” according to its proponents?

**Kuran:** The Islamists have latched onto three specific principles to distinguish their version of economics from neoclassical economics, Keynesian economics, and Marxist economics. The first is the ban on interest. If implemented, such a ban would have huge consequences. The second principle involves redistribution from rich to poor, according to an Islamic template. The Koran prescribes a form of redistribution called zakat. Islamic economists want zakat to be the foundation of redistribution. The third principle is that economic relations should be built on the norms I mentioned before: honesty, transparency, and justice. As I have already said, these can be extracted from the Bible as easily as from the Koran.

These three principles are compatible with a wide array of economic systems. This is evident from the diversity of the economic agendas characterized as Islamic. Some Islamic economists have inferred that they lead to Islamic socialism. Others have used the same principles to rationalize free markets.

**RF:** How commonly do we observe those three principles actually being practiced in Islamic countries?

**Kuran:** Certain societies have made interest illegal. But there is no example of either a Muslim or non-Muslim society, past or present, that has done away with interest in practice. There is always a demand to borrow money at interest. That demand induces people to find ways to circumvent the ban.

As a redistribution system that emerged in seventh-century Arabia, zakat reflects seventh-century Arabian conditions. It requires wealth holders to transfer shares of their precious metals, camels, and crops to the poor. The requirements are highly specific; for that reason they lost relevance as the early Arab empires conquered Syria, Iraq, and Egypt, all relatively urbanized societies with a different resource base than largely nomadic Arabia. Islamic economists have tried to restore the significance of zakat. Some have argued that rates set centuries ago should be implemented today, and that the taxable commodities should remain the same.

Where these traditionalists have had their way, there have been perverse consequences. In Malaysia, for instance, zakat has been collected from peasants but not from urban workers or civil servants. As a result, inequality has actually increased. The majority of Islamic economists are now trying to reinterpret zakat to suit modern conditions. Some have called for a radical reinterpretation: Wealth should be shared not only within Muslim countries but also among them. If the radicals get their way — unlikely anytime soon — the richer Muslim countries would redistribute wealth to the poorer ones.

**RF:** The Islamic world was relatively prosperous during the Middle Ages but then suffered through a long period of near stagnation. What accounts for that?

**Kuran:** The Middle East and Europe started out with similar commercial institutions around the year 1000. The institutions used to pool labor and capital were not different in any essential respect. But the European variants adapted much more quickly to changing circumstances than those of the Middle East. Evidently there were greater incentives to innovate in Europe than in the Middle East. Why? One important difference involved inheritance practices. The Koran prescribes a highly egalitarian inheritance system. All children, including daughters, get a share of the estate. There was a downside to this egalitarianism. The estates of successful businessmen tended to get fragmented, making it difficult for successful businesses to
The problem was exacerbated by another Islamic institution: polygamy. The wealthiest members of a Muslim community tended to have multiple wives and, hence, many more children than the norm. Precisely because they were wealthy, their children tended to survive in greater numbers. So when a wealthy businessman died, there tended to be many inheritors. In principle, the inheritors could have banded together to keep the family business going. In practice, such cooperation was uncommon. We know of great entrepreneurs in premodern Egypt and Turkey who built a massive business network, amassed a great deal of capital, and developed a stellar reputation. Their business empires did not survive them.

In Europe, there existed a wide variety of inheritance systems. The one that contributed most to economic growth and modernization, especially in Great Britain, Holland, Belgium, Switzerland, and parts of France, was primogeniture. Under primogeniture the entire estate goes to the eldest son. It is not by chance that these countries developed more rapidly than other parts of the world. In contrast to the Islamic inheritance system this form of inheritance enables business continuity across generations. Ironically, the Islamic system is relatively more egalitarian, and it conforms more closely to modern sensibilities. Nevertheless, it had the effect of retarding economic modernization and, ultimately, industrialization.

Because of the prevailing inheritance system in the Middle East, people tended to keep their partnerships small and ephemeral. In Western Europe, where the fragmentation of estates could be prevented, people were willing to form large and durable partnerships. Larger and longer-lasting partnerships created problems of coordination, communication, and risk-sharing. Efforts to alleviate these problems led to organizational advances. By the 16th and 17th centuries, business corporations were being formed in Western Europe. Nothing resembling this dynamic unfolded in the Middle East.

As these corporations became larger, their shareholders started looking for a way to withdraw capital without endangering the entire enterprise. The emergence of the early stock markets in Amsterdam and London provided this convenience. Large publicly traded companies stood to benefit from standardized accounting; it would facilitate the valuation of their shares. In the Middle East, these developments were absent because they were not needed.

What made Great Britain an industrial power was not only the invention of technologies such as the steam engine. In the 19th century one could easily ship a steam engine to Cairo. However, Cairo lacked the institutions of modern capitalism, so it could not have used a steam engine efficiently. Institutions are critical to economic performance, and in the course of the second millennium they became increasingly sophisticated in Western Europe but essentially stagnated in the Middle East. This is the basic argument of my book to be published in 2010 by Princeton University Press, tentatively titled *Islam and Economic Underdevelopment: Legal Roots of Organizational Stagnation in the Middle East*.

In researching this book, I looked at about 10,000 commercial cases from the 17th century, all recorded in the court archives of Istanbul. Why Istanbul and why the 17th century? Until modern times Istanbul was the most advanced commercial center of the Eastern Mediterranean, and it was during the 17th century that organizational forms in Western Europe registered the advances essential to modern economic life. My goal was to see whether parallels existed in Istanbul.

I plan to continue mining the resulting data set in forthcoming papers. Because the original documents may prove useful to other researchers working on related questions, I will also be publishing the data set itself. A 10-volume collection of 17th-century court cases will appear in 2010. It will contain summaries in English and modern Turkish, along with transliterations of the Ottoman-Turkish transcripts.

**RF:** I have noticed that you typically use the word “underdeveloped” rather than “developing,” which seems to be the preferred term among economists in this field. Is your choice of words meant to represent an important distinction?

**Kuran:** “Developing” is a euphemism that emerged in the 1970s to describe what used to be called “backwardness” or “underdevelopment.” It was considered a more gentle, and thus more acceptable, alternative to the term I prefer to use, “underdeveloped.” Yet some of the countries lumped together under the rubric “developing” have not been developing in any meaningful sense; they have become poorer, not richer. To call them “developing” does not do their people any good; on the contrary, it does harm by obscuring the need for fundamental reforms. Terms ought to illuminate phenomena, not obfuscate them.

“Underdeveloped” is a more satisfactory term for my purposes because it signals my concern with relative economic performance. During the second millennium, the Middle East continued to grow, though more slowly than Western Europe. My central question is whether Islam contributed to turning the Middle East into a region that is poorer than Europe.

**RF:** What is your next project?

**Kuran:** I have now turned my attention to political underdevelopment in the Middle East. Where the book about to be published focuses on commerce and finance, the next one will focus on democratization, political liberties, and the evolution of governance patterns. The Islamic world’s political underdevelopment has to do with failures to develop political checks and balances; and those failures are related to the very institutions that led to economic underdevelopment. Economic and political liberalization are mutually supportive processes.
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The rescue of Long-Term Capital Management

When the Russian government defaulted on its debts to bondholders on Aug. 17, 1998, few could have predicted that the chain of events it sparked would culminate a little over a month later in an unprecedented meeting of the heads of the major Wall Street financing houses in the boardroom at the Federal Reserve Bank of New York. The point of that meeting was to find a way to save a particular hedge fund by the name of Long-Term Capital Management (LTCM). The company had suffered substantial losses the past month. If the firm crumbled, the companies run by all those around the conference table at the New York Fed would see big losses related to their investments in and loans made to LTCM.

At the heart of the New York Fed's involvement in facilitating the meeting was a concern about the systemic ramifications the failure of a firm like LTCM would have on financial markets. Its involvement was seen largely as making explicit a sometimes implicit notion that some firms are simply too big — or too interconnected with others — to be allowed to fail. Some argue that the Fed's actions in this case have changed the financial world's assumptions about risk-taking.

Sucking Up Nickels

Started in 1993 by former Salomon Brothers bond trader, John Meriwether, Long-Term Capital Management was a hedge fund based on a simple premise. The analysts at the firm would look for bonds that had a predictable spread between their yields over a specific time period. Whenever the observed spread would widen, the LTCM traders operated under the assumption that it would eventually narrow again. So they would invest in derivative contracts that paid off when the spreads narrowed. This is the classic model of “arbitrage.”

One element in the LTCM approach was that the firm used complex mathematical models to find connections between yields of a variety of different bonds. Whereas the traditional arbitrage opportunities occurred in markets of fairly conventional bonds, the LTCM analysts cast a broad net and looked for all sorts of correlations between yields in various markets. The firm capitalized on advances in data mining technology and a greater sophistication of the finance models on which their internal analysis was based.

Another characteristic was that the firm had as two of its partners Myron Scholes and Robert Merton, both of whom would in 1997 win the Nobel Prize in Economics for their contributions to financial economics. The approach LTCM used was based on their economic models. At the firm's inception, the star power of both Scholes and Merton — already well-known in their field — was an attractive enticement to potential investors in LTCM. It and Meriwether's reputation from his days at Salomon Brothers helped attract $1.25 billion in startup capital by the time the firm began its trading operation in 1994. Investors included Goldman Sachs, J.P. Morgan, and Merrill Lynch. The LTCM partners also kicked in a total of $100 million of their own money.

The final element of the firm's strategy was leverage. The business of arbitrage assumes there are small marginal differences between prices that can be exploited. Such an investment strategy might be described, as Scholes is said to have suggested, as “sucking up nickels from all over the world.” But if the spread between yields is so small, so are the payouts on investments based on those spreads. Thus, to make it worthwhile to place the bets LTCM did, the bets themselves had to be large. That meant the firm would borrow large sums, using the derivative contracts as collateral. Leveraging like this was a common practice on Wall Street, and the assumption was that the bets would pay off eventually and the loans could be paid back.

In the case of LTCM, the bets usually did pay off, and quite well. As the Wall Street Journal reported, “the fund's returns hit 42.8 percent in 1995, then 40.8 percent in 1996, after fees. That far outpaced hedge funds' average performance of 16 percent and 17 percent, respectively.” By the middle of 1996, the partners had tripled their original investment.

A Shock to the System

Starting in 1997, LTCM began to lose steam. Part of the reason was that the bond markets they traded in became too crowded — many investors were trying the sort of thing that LTCM did. The profits were getting smaller as a result, and the firm's computer models were finding fewer arbitrage opportunities. That year, the firm's return dropped to a more conventional 17 percent after fees.

At this point, LTCM still had $7 billion in capital. But then the investment philosophy had begun to change. LTCM began trading emerging-market debt and also started speculating in foreign currencies.

Some of the partners, most notably Scholes, were uneasy about this. When the firm took a big stake in the future of the Norwegian kroner, Scholes warned that the firm didn't have an “informational advantage” in that market and it should stick to what the firm's models could handle well.
Soon, murmurs of unease in foreign bond markets didn’t bode well for the firm. In June 1998, LTCM racked up a 10 percent loss, their largest one-month loss to date.

Then came the biggest shock of all. On Monday, August 17, the Russian government defaulted on its debt and let its currency plummet. This triggered a flight to more stable assets, like U.S. Treasury bonds. This created problems for LTCM’s balance sheet, and not just because the fund held a large number of Russian bonds outright. The events also threw off the well-defined and predictable pattern of interest rate spreads upon which the firm’s derivative investments in domestic and foreign bonds relied. Now, instead of interest rates converging, the massive rush to more secure bonds — an anomalous occurrence in the assumptions of LTCM models — were driving the rates further apart.

As the week wore on, things got worse. As Roger Lowenstein, author of *When Genius Failed: The Rise and Fall of Long-Term Capital Management*, described it: “Long-Term, which had calculated with such mathematical certainty that it was unlikely to lose more than $35 million on any single day, had just dropped $553 million — 15 percent of its capital — on that one Friday in August. It had started the year with $4.67 billion. Suddenly, it was down to $2.9 billion. Since the end of April, it had lost more than a third of its equity.”

The firm’s partners scrambled for more capital. One of the partners, Eric Rosenfeld, made an overture to Warren Buffett with a request for the Berkshire Hathaway CEO to invest in LTCM. He was initially rebuffed. Buffett, although intrigued, thought the firm would be better served by having a Wall Street securities firm bolster its balance sheet.

Such insight was not lost on the partners. In fact, they had already begun to redouble their efforts to get more Wall Street investment, but they weren’t getting much in the way of positive responses. Large institutional investors like Merrill Lynch declined to invest more in the fund. Meanwhile, the firm’s lenders were becoming uneasy; understandably worried about LTCM’s ability to repay its loans.

Meriwether still believed that their trades would pay off if they could simply weather the storm. The nature of most of their trades, after all, required a long-term view. But the lack of cash on hand coupled with the increasing buzz that creditors were beginning to consider LTCM a default risk created an environment where the partners were willing to do almost anything to get help.

By September 17, Meriwether had worked out a deal with Goldman Sachs co-chairman, Jon Corzine, that Goldman would lead an investment group to raise at least $2 billion in capital. The next day, Corzine (now a U.S. Senator from New Jersey) called the president of the New York Fed, William McDonough, and told him that LTCM was “weak,” but Goldman was trying to help them re-capitaliz. To make sure that McDonough had a pair of eyes on the situation, he called Peter Fisher, the head of the New York Fed’s trading desk that handled the bond sales which carry out the Fed’s monetary policy. Fisher was dispatched to Greenwich, Conn., where LTCM was headquartered to take a look at the firm’s books on September 20.

When the fundraising push began, however, Corzine discovered that LTCM had already been rebuffed by the same people that Goldman planned to approach for funding. Then Corzine decided to call the New York Fed again to let them know that a new plan had to be hatched quickly and that the Fed needed to help.

### The Rescue

The scenario that scared the New York Fed policymakers went like this: LTCM, in its weakened state, would eventually have to succumb to demands by fearful lenders for increased collateral, which could then spur a default by the hedge fund and set off not only fire-sale panic selling of any derivative contracts with LTCM’s name attached but also heavy losses for firms that had made similar investments. Add to the mix the crater that would open up in the balance sheets of LTCM’s creditors, and Fed officials believed that the larger financial system could be at risk.

After his trip to Connecticut, Fisher and McDonough decided to work with the big institutional investors in LTCM — Merrill Lynch, Goldman Sachs, and J.P. Morgan — to find a way to save LTCM. On the morning of September 22, the lead representatives from these firms met at the New York Fed. By later that day, the group had determined that the firms present would be the lead members in an investment consortium to keep LTCM afloat.

At about 8 p.m., Fisher convened a meeting of the heads of the original trio and other big Wall Street firms — including Chase Manhattan, Lehman Brothers, Morgan Stanley, Dean Witter, and Salomon Smith Barney. Press reports later suggested that Fisher did not hint explicitly at using public money to help LTCM. Instead, he observed that a collapse of the hedge fund would be too chaotic for the markets to handle and suggested that there was “a public interest in a collective industry option” to keep LTCM from collapsing. The plan was to ask each firm present to chip in and save the hedge fund in exchange for an ownership stake and oversight of operations. After discussing details, the meeting adjourned until the following morning.

But when the meeting participants arrived the next morning, McDonough abruptly suspended the meeting. That morning, Warren Buffett had faxed an offer to Meriwether stating that he, in partnership with insurance giant AIG and Goldman Sachs, would be willing to buy LTCM for $250 million. If the partners of LTCM agreed to the deal by 12:30 p.m. that day, Berkshire Hathaway would immediately invest $3 billion to stabilize the fund. Another $750 million would come from the other two firms. In addition, Buffett’s offer noted that new leadership would be installed at LTCM once the buyout had occurred.

When Buffett’s representatives met Meriwether in Connecticut before the deadline, Meriwether turned down the offer. Some observers note that he likely did it because he knew he could get a better deal from the Fed-facilitated
consortium. Others point to legal problems with the structure of LTCM and the way the Buffett offer was worded. Yet, as Lowenstein notes, the legal niceties of deals like that are often worked out after the fact. If Meriwether wanted to accept the Buffett deal, he probably could have.

In any case, the attention of everyone involved was again focused on the conference room at the New York Fed. By 5:15 p.m., a deal had been worked out in which most of the participants at the meeting agreed to pitch in to purchase the firm for $3.65 billion. The 14-member group would collectively receive a 90 percent equity stake in the firm. The LTCM partners would get the remaining 10 percent, worth about $400 million. LTCM agreed to the offer and the legal matters were settled in the weeks following.

The Aftermath

The day after the deal was announced, the press focused mainly on the Fed’s role in the proceedings. The New York Times suggested that the Fed had inappropriately stretched the doctrine of “too big to fail” to apply to a high-risk hedge fund.

The assumption that there was a systemic risk present in a potential LTCM default is as controversial a notion today as it was then. In congressional testimony on the LTCM affair in October 1998, Federal Reserve Chairman Alan Greenspan defended the New York Fed’s actions this way: “The issue was in all of our judgments that the probability [of systemic collapse] was sufficiently large to make us very uncomfortable about doing nothing.” When questioned about where he would place that probability, Greenspan responded: “My own guess is that the probability was significantly below 50 percent, but still large enough to be worrisome.”

Roger Lowenstein reports in his history of LTCM that Fisher and McDonough were both aware that estimates of $3 billion to $5 billion in losses would have been spread over about 17 banks. That would have been up to $300 million per firm. In a worldwide capital market of many trillions of dollars, even they agreed it would have been tolerable.

The main concern was that the losses would instill fear in the markets and that would create a system-wide panic. The assumption here is that market participants would not have been able to determine which institutions were most heavily invested in LTCM and which were not. That opacity could have contributed greatly to the systemic uncertainty which was feared.

The fear of uncertainty, in retrospect, may not have been on such solid ground. Analysis by Bong-Chan Kho of Seoul National University, Dong Lee of Korea University Business School, and René Stulz of Ohio State University sheds some light on the state of market information about individual firm exposures. They looked at the response of bank stocks during the LTCM crisis. For four of the banks that attended the meeting at the New York Fed, they found significantly negative returns on the days surrounding the announcements of LTCM’s losses in early September. That contrasts with positive returns for banks not exposed to LTCM investments. They conclude that there is “no basis for concerns that markets react similarly across banks and that banks have to be protected from the markets. Our evidence raises important questions, especially for those who emphasize the importance of U.S. systemic risks as a motivation for bailouts.”

Another criticism suggests that the Fed already had more traditional policy tools at its disposal. Instead of seeking to broker a deal between private parties to keep LTCM afloat, it could have instead remained detached from any specific resolution and stood ready to open the discount window to any depository institutions that may have been affected by the events.

The biggest policy question, however, should be focused on how the Fed’s actions influenced the assumptions of the market. Some argue that the Fed’s response in this event sent a strong signal that it was much less likely to tolerate the failure of a firm which might result in widespread losses and have potentially large systemic implications. That expectation — the too big to fail assumption — brings with it social costs. It encourages behavior that might not otherwise occur except for the presence of an implicit Fed guarantee to backstop a firm plagued by bad investments.

Some argue that the recent troubles with large and highly leveraged investment houses are a direct result of the idea that Wall Street generally assumed the Fed wouldn’t let a large firm fail. Whether that is the main legacy of the Fed’s role in the LTCM story — and whether it should be an approach to be emulated or avoided in the future — is a debate that will continue for quite some time.

Readings


Standards of living tend to vary more among countries than they do among states within the United States. Perhaps not surprisingly, residents of the Fifth Federal Reserve District enjoy a standard of living similar to that of communities across the nation. In this section, we take a look at some indicators used to assess standard of living and see how the Fifth District stacks up. Some of the indicators may be a necessary condition for an increased standard of living while others may simply be associated with it.

**Personal Income**
Real per-capita income by state includes wage and salary disbursements (by place of residence), supplements to wages and salaries, proprietors’ income, dividends, interest, rent, and personal current transfer receipts, such as individual Social Security and unemployment, minus employer contributions for Social Security.

Real per-capita personal income has grown steadily in the United States and the Fifth District over the past 60 years. In the District of Columbia, real personal income grew quickest in the last decade, nearly 43 percent since first quarter 1999. (Nationally, the rate was 14 percent.) Although 2009 is not displayed in the graph above, D.C., Maryland, and Virginia exceeded the national mark of $32,489 per person, while North Carolina, South Carolina, and West Virginia ranked below the national average.

**Measuring Poverty**
An indicator for the share of a population living in poverty is a useful companion to a per-capita income measure when examining living standards. The Census Bureau uses a set of income thresholds that vary by family size and composition to detect who is poor. If the total income for a household falls below the relevant poverty threshold, then the household is classified as being “below the poverty line.” The map of the Fifth District identifies several counties in West Virginia and on the border between the Carolinas with a notably high share of households with income below the poverty line. The District of Columbia stands out as having the highest per-capita income, but also the highest share of households living below the poverty line.

**Education**
Educational attainment refers to the highest level of school completed by members of a population. Each category in the following table represents the portion of the population that has attained at least that educational level. For example, a person with a bachelor’s degree has obtained a high school degree, but will show up in the share of the population with a bachelor’s degree rather than the share of the population with a high school degree. So, although it appears that 41.9 percent of West Virginians graduated from high school compared to 30 percent of all Americans, a smaller percentage of West Virginians continued beyond high school than in the United States generally.

It should be noted that many economists do not consider educational attainment as a measure of a person’s standard of living. Instead, they claim, education often increases a person’s earning power, leading to more...
consumption, which can improve well-being. However, there are nonfinancial benefits to educational attainment as well. For instance, in a recent paper, economists Philip Oreopoulos and Kjell Salvanes acknowledge economists’ traditional way of looking at educational attainment as an input to well-being rather than as a good itself. But they argue, “Experiences and skills acquired in school reverberate throughout life, not just through higher earnings.”

Infant Mortality
Infant mortality gives us an indirect way to measure the underlying health of mothers, public health practices, socioeconomic conditions, and availability and use of appropriate health care for infants and pregnant women. Rates are calculated by dividing the number of infant deaths by the number of live births reported during the calendar year. Fifth District states have consistently reported infant mortality rates above the corresponding national mark.

According to the Centers for Disease Control and Prevention (CDC), the leading causes of mortality in an infant’s first 28 days are congenital malformations and disorders related to short gestation and low birth weight. For the following 11 months of the first year, the leading causes of death are Sudden Infant Death Syndrome and congenital malformations.

Although infant mortality rates have improved, the District of Columbia maintained the highest rate in the Fifth District (12.2 deaths per 1,000 live births) in the most recent year available. With 7.5 deaths per 1,000 live births, the state with the lowest rate (Virginia) came closest to the national mark of 6.8 deaths.

Life expectancy
Although life expectancy can vary widely among countries, the measure does not differ notably among states. With the exception of the District of Columbia, life expectancy among states in the Fifth District varied by only two years in 2000 — between 74.9 years in South Carolina and 76.9 years in Virginia. The D.C. rate of 72.6 years was pulled down by the significantly lower life expectancy among men (68.5 years).

Although the availability of time-series data on life expectancy by state is limited, it is likely that life expectancy across states has risen along with the nation. According to the CDC, life expectancy in the United States as a whole, the average woman lives 5.4 more years than the average man.

Although the District of Columbia had the sharpest difference in life expectancy between women and men (7.6 years), women generally have a higher life expectancy than men. In the Fifth District, the gender difference ranged from 4.9 years in Virginia to 6.2 years in South Carolina. In the United States as a whole, the average woman lives 5.4 more years than the average man.
Earn More, Work More: How Leisure Time Has Changed

BY BETTY JOYCE NASH

ow people use their nonwork time can be a bellwether for national well-being. Time use also influences labor markets in terms of how much time people are willing to “pay” for leisure — i.e., how much work they’ll forgo for play as well as the reverse.

Time spent in leisure has increased over the last century, but by how much? It depends on the measure. Economists measure leisure using census and Current Population Survey data, a range of government statistics, and time-use diaries, among other data.

The dimensions and documentation of work and leisure are fuzzy. “If you look at the history of the length of the workweek, the official statistics we have give us ballpark figures, but can’t be as precise as they pretend to be,” says Robert Whaples, an economic historian at Wake Forest University. Before the Civil War, for instance, most Americans worked in agriculture. There, the distinction between work and leisure is difficult to draw.

Leisure Inequality

The workweek has shortened, on average, for everyone compared to 100 years ago. But newer time-use studies have documented a “leisure inequality.” In the 1890s, only the highest earners could afford leisure time — they worked about two hours less per week than the lowest wage earners.

But today, people who are less educated and earn less money enjoy more leisure time. “It used to be that leisure was almost a sign of affluence,” says Whaples. “Now it goes in the other direction.”

Many jobs are less onerous than they were a century ago. “Back in the old days, I’m tending a machine and it’s pretty clear I’m doing something I wouldn’t be doing otherwise,” Whaples says. Now, many well-educated professionals work more than 40 hours in salaried jobs. Economists Mark Aguiar and Erik Hurst documented an increase in leisure inequality that started in about 1985. (The authors controlled for involuntary unemployment and disabilities that might prevent work.) Between 1965 and 2003, men with a high school diploma gained about 7.3 hours more leisure while men with a bachelor’s degree had no change in leisure.

Using five decades of time-use surveys, Aguiar and Hurst examined four uses of time for people aged 21 to 65: work on the job, work at home, child care, and pure leisure.

Using a narrow definition of leisure (entertainment, socializing, active recreation and general relaxation), Aguiar and Hurst found that between 1965 and 2003, leisure for men increased by 6.2 hours a week because of fewer hours on the job. Women’s leisure increased about 4.9 hours. They spent more hours on the job but fewer on home chores.

Life-Cycle Leisure

Economist Valerie Ramey of the University of California, San Diego compiled multiple data sources to measure time use among the total population in the United States over the past century with her co-author Neville Francis of the University of North Carolina at Chapel Hill.

Their conclusion: Leisure per person today is similar to leisure time in 1900. By way of example, Ramey describes the life of an average working man in 1900, who may have worked 58 or 49 hours per week instead of today’s 40 hours.

The difference in hours can’t be all leisure. In 1900, the average working man did few chores at home, she says. That work was done by wives or the proprietors of the boarding houses where they lived. “Home production and chores for males have gone from three to four hours a week in 1900 to, by some measures, 15 or 16 hours a week.

“So while the time spent working for a male has decreased by 16 hours a week, the time spent working at home has gone up by 12 hours a week,” Ramey says.

Ramey and Francis included paid hours in the private sector, government work, and unpaid family labor, especially on farms. The authors also included time spent in school because a typical 15-year-old boy in 1900 worked during his schooling years. Today, while his work hours have declined, his time is spent in school, not at leisure.

Using this wide range of resources, the authors found that leisure time has increased very little. “Single people, for instance, have much more leisure today,” Ramey says, an increase of about five hours a week. But among those in their prime working years, 25- to 54-year-olds, “It’s not seeing much more leisure for them now than I did 100 years ago. The people who have increases in leisure are older people and people between 18 and 24.” That group gained five hours of free time while the over-65 set gained 14 hours per week.

More lifetime leisure may be good news but it’s a mixed blessing: Aguiar and Hurst say this prime leisure time is devoured by television, 6.7 hours weekly for men and eight hours for women. That leaves little remaining time for the activity TV replaced: socializing and reading.
## State Data, Q1:09

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<td><strong>Unemployment Rate (%)</strong></td>
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<td><strong>Real Personal Income ($Mil)</strong></td>
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<td>Y/Y Percent Change</td>
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<td><strong>House Price Index (1980=100)</strong></td>
<td>608.9</td>
<td>483.6</td>
<td>346.2</td>
<td>327.4</td>
<td>447.2</td>
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<td>Q/Q Percent Change</td>
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<td><strong>Sales of Existing Housing Units (000’s)</strong></td>
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<td>Y/Y Percent Change</td>
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**NOTES:**
- Nonfarm Payroll Employment, thousands of jobs, seasonally adjusted (SA) except in MSAs; Bureau of Labor Statistics (BLS)/Haver Analytics, Manufacturing Employment, thousands of jobs, SA in all but DC and SC; BLS/Haver Analytics, Professional/Business Services Employment, thousands of jobs, SA in all but SC; BLS/Haver Analytics, Government Employment, thousands of jobs, SA; BLS/Haver Analytics, Civilian Labor Force, thousands of persons, SA; BLS/Haver Analytics, Unemployment Rate, percent, SA except in MSAs; BLS/Haver Analytics, Building Permits, number of permits, NSA; U.S. Census Bureau/Haver Analytics, Sales of Existing Housing Units, thousands of units, SA; National Association of Realtors®.
Projected annual growth in real personal income is expected to be 5% in both the U.S. and the Fifth District. Metropolitan area real personal income growth is projected to be 3% in both the U.S. and the Fifth District.

Unemployment rates are expected to decrease in both the U.S. and the Fifth District, with a projected decrease of 0.5% in both regions. Metropolitan area unemployment rates are also expected to decrease, with a projected decrease of 0.5% in both the U.S. and the Fifth District.

Manufacturing composite index is expected to decrease by 1% in the U.S. and the Fifth District. Metropolitan area manufacturing composite index is expected to decrease by 1% in both the U.S. and the Fifth District.

The building permits index is expected to decrease by 5% in both the U.S. and the Fifth District. Metropolitan area building permits index is expected to decrease by 5% in both the U.S. and the Fifth District.

House prices are expected to decrease by 3% in both the U.S. and the Fifth District. Metropolitan area house prices are expected to decrease by 3% in both the U.S. and the Fifth District.

NOTES:
1) FRB—Richmond survey indexes are diffusion indexes representing the percentage of responding firms reporting increase minus the percentage reporting decrease. The manufacturing composite index is a weighted average of the shipments, new orders, and employment indexes.
2) Metropolitan area data, building permits, and house prices are not seasonally adjusted (nsa); all other series are seasonally adjusted.

SOURCES:
Real Personal Income: Bureau of Economic Analysis/Haver Analytics.
### Metropolitan Area Data, Q1:09

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<td>Y/Y Percent Change</td>
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<td><strong>Unemployment Rate (%)</strong></td>
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<td>Q2:08</td>
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<td><strong>Unemployment Rate (%)</strong></td>
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<td>11.3</td>
<td>7.6</td>
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<td><strong>Unemployment Rate (%)</strong></td>
<td>11.2</td>
<td>8.5</td>
<td>10.3</td>
</tr>
<tr>
<td>Q2:08</td>
<td>7.9</td>
<td>5.9</td>
<td>7.3</td>
</tr>
<tr>
<td>Q3:07</td>
<td>5.3</td>
<td>4.0</td>
<td>4.9</td>
</tr>
<tr>
<td><strong>Building Permits</strong></td>
<td>483</td>
<td>818</td>
<td>455</td>
</tr>
<tr>
<td>Q/Q Percent Change</td>
<td>-17.3</td>
<td>-34.2</td>
<td>-9.9</td>
</tr>
<tr>
<td>Y/Y Percent Change</td>
<td>-52.8</td>
<td>-73.8</td>
<td>-64.3</td>
</tr>
</tbody>
</table>

For more information, contact Sonya Ravindranath Waddell at (804) 697-2694 or e-mail sonya.waddell@rich.frb.org
## Metropolitan Area Data, Q1:09

<table>
<thead>
<tr>
<th>Metropolitan Area</th>
<th>Winston-Salem, NC</th>
<th>Charleston, SC</th>
<th>Columbia, SC</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Nonfarm Employment (000’s)</strong></td>
<td>212.1</td>
<td>291.3</td>
<td>359.3</td>
</tr>
<tr>
<td>Q/Q Percent Change</td>
<td>-2.0</td>
<td>-2.4</td>
<td>-1.6</td>
</tr>
<tr>
<td>Y/Y Percent Change</td>
<td>-3.3</td>
<td>-2.2</td>
<td>-1.8</td>
</tr>
<tr>
<td><strong>Unemployment Rate (%)</strong></td>
<td>9.9</td>
<td>8.9</td>
<td>8.6</td>
</tr>
<tr>
<td>Q4:08</td>
<td>71</td>
<td>6.9</td>
<td>71</td>
</tr>
<tr>
<td>Q1:08</td>
<td>4.9</td>
<td>4.5</td>
<td>4.9</td>
</tr>
<tr>
<td><strong>Building Permits</strong></td>
<td>142</td>
<td>551</td>
<td>923</td>
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<tr>
<td>Q/Q Percent Change</td>
<td>-46.0</td>
<td>-31.0</td>
<td>49.6</td>
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<tr>
<td>Y/Y Percent Change</td>
<td>-82.6</td>
<td>-58.7</td>
<td>-10.9</td>
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</table>

<table>
<thead>
<tr>
<th>Greenville, SC</th>
<th>Richmond, VA</th>
<th>Roanoke, VA</th>
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</thead>
<tbody>
<tr>
<td><strong>Nonfarm Employment (000’s)</strong></td>
<td>311.1</td>
<td>607.4</td>
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<td>Q/Q Percent Change</td>
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<tr>
<td>Y/Y Percent Change</td>
<td>-2.5</td>
<td>-3.2</td>
</tr>
<tr>
<td><strong>Unemployment Rate (%)</strong></td>
<td>9.5</td>
<td>7.5</td>
</tr>
<tr>
<td>Q4:08</td>
<td>7.2</td>
<td>5.0</td>
</tr>
<tr>
<td>Q1:08</td>
<td>4.8</td>
<td>3.7</td>
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<tr>
<td><strong>Building Permits</strong></td>
<td>404</td>
<td>537</td>
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<td>Q/Q Percent Change</td>
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<td>-48.6</td>
</tr>
<tr>
<td>Y/Y Percent Change</td>
<td>-65.6</td>
<td>-67.9</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Virginia Beach-Norfolk, VA</th>
<th>Charleston, WV</th>
<th>Huntington, WV</th>
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<tbody>
<tr>
<td><strong>Nonfarm Employment (0000)</strong></td>
<td>752.2</td>
<td>149.0</td>
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<td>Q/Q Percent Change</td>
<td>-1.9</td>
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<tr>
<td>Y/Y Percent Change</td>
<td>-0.7</td>
<td>-0.6</td>
</tr>
<tr>
<td><strong>Unemployment Rate (%)</strong></td>
<td>6.9</td>
<td>5.7</td>
</tr>
<tr>
<td>Q4:08</td>
<td>4.9</td>
<td>3.3</td>
</tr>
<tr>
<td>Q1:08</td>
<td>3.9</td>
<td>4.1</td>
</tr>
<tr>
<td><strong>Building Permits</strong></td>
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<td>28</td>
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<tr>
<td>Q/Q Percent Change</td>
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<td>-50.9</td>
</tr>
<tr>
<td>Y/Y Percent Change</td>
<td>-14.2</td>
<td>-28.2</td>
</tr>
</tbody>
</table>

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A Case Against “Do Something” Policymaking

BY ROBERT L. HETZEL

In response to the current world recession, governments and central banks have undertaken dramatic policy initiatives. They have enacted fiscal stimulus packages to jump-start spending by the public. Similarly, they created financial-aid packages to recapitalize banks and remove their distressed assets in order to restart lending and further jump-start spending by the public. But are these initiatives the result of calculations made by economists using models widely vetted and supported within the economics profession? Or are they simply meant to respond to the “do something” imperative of the crisis?

If the policy initiatives fall into the latter category, do they really treat the causes or merely the symptoms? A symptom of recession is that public spending is not at the level it would be if the economy were at full employment. But does it then follow that the government should make up the difference? Another symptom of recession is that banks do not lend at the full employment level. So, does it again follow that governments and central banks should make up the difference here?

Seemingly intuitive responses to the distress suffered during recessions can not only be ineffective but also harm long-term economic growth. In recession, the imperative to end suffering leads to policies that interfere with markets and supersede the working of the price system. Indeed, government intervention to deal with recessions creates the perception that government is fixing a problem created by free markets. These interventions tend to limit failures among financial institutions and restrict the market allocation of credit. A trade-off appears to arise between policies that engender secular growth and policies that mitigate cyclical fluctuations.

When economists examine the circumstances surrounding the fluctuations in output over time, they see a correlation between financial instability (reflected in interruptions in the flow of credit) and real instability. But to make policy, policymakers need to judge whether this correlation reflects the cause or the symptom. If financial instability is indeed the cause, what is its origin? Is it due to the excessive risk-taking arising from the herd instincts of investors — the proverbial speculative mania of greedy investors? Or is it due to the excessive risk-taking arising from a financial safety net that socializes losses while preserving private gains?

The understanding that policymakers have of the relationship between risk-taking in financial markets and macroeconomic stability will affect government regulation of risk-taking. The regulations will, in turn, affect the nature of financial innovation and, as a result, the ability of markets to increase living standards over time.

It’s important to remember that financial innovation has been a powerful contributor to the rise in welfare. For example, the ability of families to smooth their consumption over time through the use of credit can make them better off. This ability derives from the broader availability of credit instruments to individuals. So, the policy question should be whether the current system combines a financial safety net with government regulation of risk-taking by financial institutions that promotes the optimal amount of welfare-improving financial innovation.

Policymakers should ask whether the current system skews innovation toward strategies that provide high returns to financial institutions in good times while imposing losses on taxpayers in bad times — and, if so, how to most effectively alter that incentive. The public might be best served if regulators devised ways of committing not to bail out creditors of financial institutions.

More generally, rules should replace discretion. With respect to monetary policy, many central bankers accepted the perennially popular explanation of cyclical fluctuations as a manifestation of speculative euphoria followed by a bust. At present, high-risk premia and the shift from securitization in capital markets to borrowing from banks appear as evidence that financial markets are no longer facilitating the transfer of funds between savers and investors. However, if these are only symptoms of the increased probability of default in recessions, the diagnosis diverts attention away from the money creation required to stimulate spending. As a by-product of intervention into specific credit markets that many central banks have undertaken, monetary authorities may eventually create enough money to stimulate spending. But there is no assurance that it will be aggressive enough. Moreover, there is no assurance that central banks will follow a longer-run strategy to withdraw the resulting monetary overhang when the economy recovers.

So, the creation of rules for monetary and regulatory policy that incorporate lessons from historical experience is important to the functioning of a healthy free-market economy. Central bankers will have to abandon the language of discretion for the language of rules and for the analytical framework of economics. And both central bankers and academics will have to take responsibility for conveying insights in a way that an informed public can understand.

Robert L. Hetzel is a senior economist and policy adviser at the Federal Reserve Bank of Richmond. This article is based on a longer piece published in the August 2009 issue of Economic Affairs.
Business Starts and Recessions
Everyone has heard the stories of well-known companies that got their start during past recessions such as Starbucks and PetSmart. But are business startups during economic downturns less likely to survive? We'll explore the barriers to and opportunities for entrepreneurship when the economy is slumping.

The Efficient Market Hypothesis
The financial crisis has caused some to question the validity of the “efficient market hypothesis.” Yet the origins and implications of this theory have become oversimplified in the public debate. Is it premature to pronounce the death of efficient markets?

Cash for Clunkers
While this popular program increased sales of cars, it may have simply shifted the timing of car purchases. The program also eliminated cars that could have entered the secondary market and provided low-cost alternatives to poor families. Did this well-intentioned policy meet its goals?

The Business of Higher Education
Published tuition and fee prices continue to grow at a rate faster than inflation, and even though many students don’t pay this “sticker” price, people are asking who should subsidize this service and whether postsecondary institutions could manage their business affairs more efficiently.
The Financial Crisis:
Causes and Consequences

The Federal Reserve Bank of Richmond’s 2008 Annual Report features the essay “The Financial Crisis: Toward an Explanation and Policy Response.” In it, the authors discuss the key events of the financial crisis, examine the factors that contributed to it, and consider how policymakers might most effectively respond. At the core of their discussion is the role that explicit and implicit government guarantees played in encouraging unwise risk-taking by financial institutions and the problems that can result from treating some institutions as “too big to fail.”

The authors write: “While the liberal provision of credit can cushion the effects of a crisis, expectation of such credit availability can dampen incentives to take actions that may limit the likelihood of a crisis. This trade-off lies at the heart of any effort to design a set of policies that achieves a balance between the roles of government and market forces in disciplining the incentives of participants in our financial system.”

The Annual Report also includes reports on the region’s economy and the Bank’s operational and financial activities. And it takes a special look at the Bank’s involvement in communities throughout the Fifth District.