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1 Structural Booms: Why the South Grows **Thomas J. Cunningham**

Since the end of the 1991 recession, almost 27 percent of all new jobs in the United States have been created in the six southeastern states that make up the Sixth Federal Reserve District. What accounts for this strong relative economic performance in the region?

This article examines the forces behind the South's economic strength and looks ahead at the course of its economic development in terms of three alternative approaches—the industrial base, the convergence, and the structuralist models. In evaluating the models' usefulness for thinking about why regions grow, the author finds the structuralist approach, which provides a general equilibrium model for understanding capital flows, interest rates, assets, goods, and labor market behavior, to hold the most promise as a perspective on long-term trends because it addresses the root causes of differential growth rates. This approach suggests a number of reasons for the Southeast's relatively rapid recent growth, which, taken together, give evidence of economic and social structures that may attract both employers and employees to the region at a disproportionate rate for some time to come.

11 ***FYI—Commercial
Bank Profits in 1994***

**Lynn W. Woosley and
James D. Baer**

Commercial banks enjoyed another year of high profits in 1994, reporting record net income. However, rapid asset and capital growth slightly reduced rates of return on assets and equity. Banks in the Southeast again outperformed those in the nation as a whole. This article examines the forces behind this performance, concluding that healthy economic conditions augmented banks' bottom lines by stimulating loan growth and curtailing loan losses. Much of the decline in rates of return can be attributed to changes in accounting rules, which resulted in a one-time addition to assets. Extensive tables provide data from 1990 through 1994.

32 ***Review Essay—"Privatopia"
and the Public Good***

William Roberds

In *Privatopia*, Evan McKenzie documents the history and legal structure of common interest developments, a form of residential community organization. McKenzie also looks at possible explanations for the rising popularity of these organizations despite the fact that their governing associations may impose more onerous restrictions on residents' behavior than municipal governments do. In this essay, the reviewer discusses McKenzie's explanations and adds his own based on an appreciation of the underlying economic forces that have shaped these types of communities. The reviewer concludes that the challenge for common interest developments is to devise forms of organization that incorporate efficiency advantages while ensuring greater democracy and fair play for residents.

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Structural Booms: Why the South Grows

Thomas J. Cunningham

Since the end of the 1991 recession, the six states that make up the Sixth Federal Reserve District—Alabama, Florida, Georgia, Louisiana, Mississippi, and Tennessee—have created about 1.8 million jobs while the nation as a whole has added 6.9 million. That is, only slightly less than 27 percent of all new jobs in the United States since the last recession have been created in the Southeast. This strong relative economic performance is illustrated in Chart 1.

The purpose of this article is to discuss competing explanations for this economic strength in the Southeast as well as what each of the alternative theories suggests for the course of economic development in the region. These explanations derive from three models—the industrial base, the convergence, and the structuralist models—which offer approaches that are not necessarily mutually exclusive. The models focus on different mechanisms for propelling economic growth, and each of them has elements that are more or less appropriate for explaining growth in various localities at various times. Nevertheless, while elements of all three explanations are apparent in current developments, each offers very different long-run projections for growth in the region, especially in comparison with the rest of the nation's economy. An understanding of the various theories is therefore useful for thinking about future growth in the South and particularly for formulating effective economic development strategies and policies.

This article begins with a discussion of the Southeast's economic growth since the end of the 1991 recession and the things that have distinguished its

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performance from that of the rest of the nation—that is, its comparative advantages. A natural outgrowth of this discussion is to think in terms of industrial base models, so those are considered first, turning specific attention to why they may not be appropriate for anything other than short-term projections. The next section discusses models of convergence, an old idea that has gained recent attention in the professional economic literature. In general, although this class of model has some appeal, some important questions regarding the ultimate source of differential growth go begging. The final part of the discussion centers on the new structuralist work that emphasizes differences in fundamental characteristics—economic, social, legal, and so forth—that provide structural reasons for continuing differing rates of economic growth.

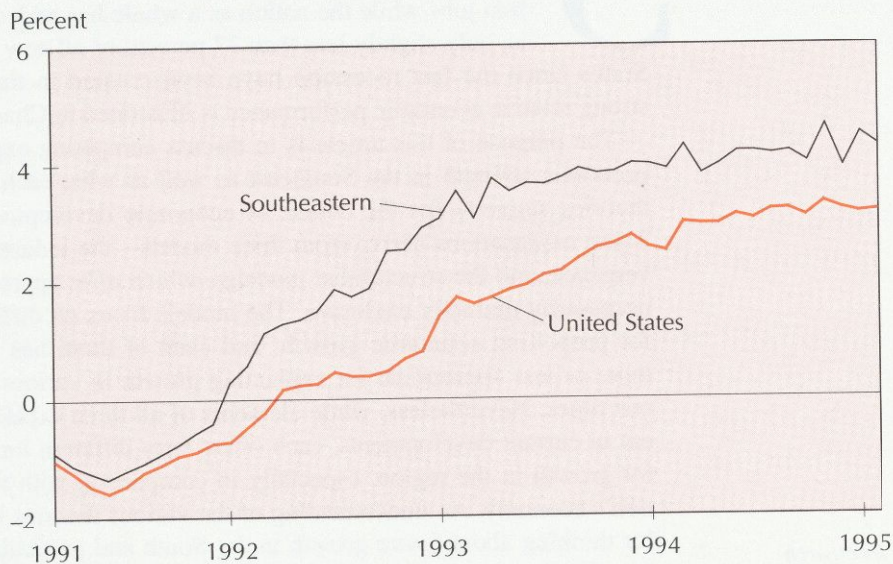
sector as a source of new jobs is not inherently more or less desirable than, say, the service sector, even though local discussion of economic development incentives usually revolve around industry. However, from the perspective of local economic development, manufacturing has the attractive feature of a more intensive use of capital equipment than many service sector jobs. And the heavier the better because heavy industrial equipment, once installed, lends an element of permanence to the associated manufacturing jobs, a permanence lacking in many service-oriented jobs whose facilities can move with relative ease.

Another popular, though somewhat misguided, notion associated with the manufacturing sector is that of the tradability of the output. For example, autos produced in one locality can be traded around the world while haircuts cannot. Presumably, then, the manufactured good can bring income into the community in a way the service sector cannot. It is true that there are many services that are location specific and that the market for manufactured goods is easily geographically wider. There are, however, many goods that are not very tradable, usually because of transportation costs associated with perishability or weight—for example, concrete. At the same time, many (relatively high-income) services, such as architecture, engineering, or

The Southeast as a Small Open Economy

While Chart 1 illustrates the disparity in the rates of job growth in the Southeast and the rest of the nation, Chart 2 singles out performance in the manufacturing sector, in which the South clearly outshone the rest of nation early in the last recovery. The manufacturing

Chart 1
Southeastern and U.S. Total Payroll
(Monthly year-over-year rates of change)



Source: Bureau of Labor Statistics; data seasonally adjusted by the Federal Reserve Bank of Atlanta.

relatively sophisticated financial services, are in fact tradable, and as transportation and communications technologies and infrastructures improve, trade in services will continue to grow.

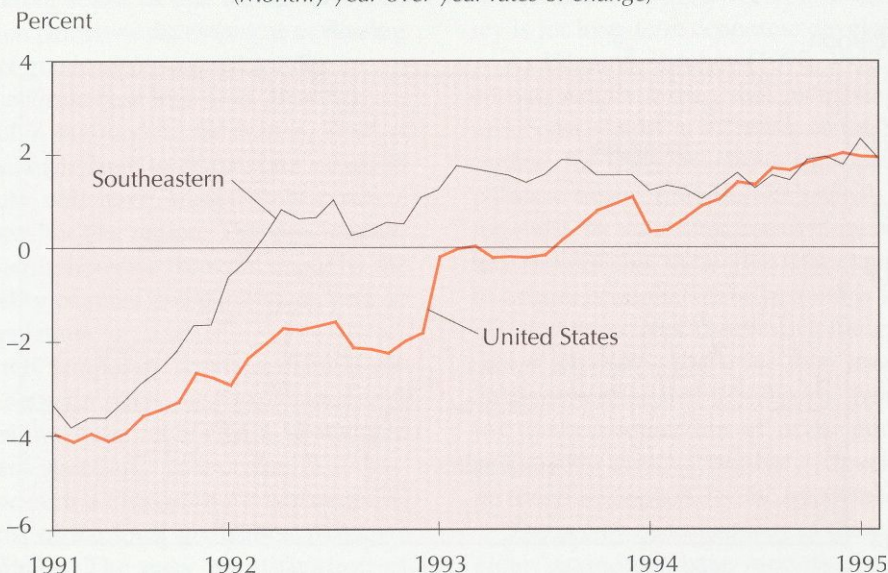
Nevertheless, because most manufactured goods are tradable, the performance of industries concentrated in a region will significantly influence the immediate, short-term relative economic performance of that area as compared with others having different manufacturing concentrations. The South has benefited from this dynamic in this most recent recovery.

In the Southeast, production of construction-related goods—for single-family residential building, in particular—is relatively concentrated. With the region's large tracts of farmed timber and a long history of investment in textile-related capital, it is not surprising that building materials such as wood products and carpeting are disproportionately found in the Southeast. Other household durable appliances, so-called white goods, like refrigerators, also have manufacturing concentrations in the South. As the economy came out of the last recession and single-family housing starts were strong both regionally and nationally, the residential building industry took off. So too did its supporting industries and the economy of the region in which they are concentrated—the South.

Manufacturing employment has also gained over the last decade as the North American auto industry has increasingly shifted its production into the Southeast. Tennessee, for example, now appears to be the geographic center of the new southern auto industry. In 1993, the state trailed only Michigan and Ohio in the number of automobiles produced. Four years earlier, Tennessee had not even made the top-ten list of auto-producing states (Tennessee Department of Economic and Community Development 1994).

Moreover, the gains associated with relocation of the auto industry came less in the actual final assembly of the autos than in the manufacture of component parts. It is in this segment of the industry that the location of auto assembly plants in the Southeast will have a disproportionate long-lasting impact. As component suppliers shift the location of their manufacturing facilities to be nearer the new assembly plants, employment gains in the local auto industry will continue to be realized even after the auto assemblers are fully stocked with workers. This migration of the parts manufacturers is likely to be gradual, as the appropriate time to relocate production may be only after an existing plant becomes fully depreciated or an existing technology becomes outmoded and such turning points are accompanied by a decision to relocate a plant closer to its final customers.

Chart 2
Southeastern and U.S. Manufacturing Payroll
(Monthly year-over-year rates of change)



Source: Bureau of Labor Statistics; data seasonally adjusted by the Federal Reserve Bank of Atlanta.

Chart 3, which shows the level of employment in transportation equipment over time, illustrates this process in Tennessee. The large early jumps reflect start-ups and staffing increases in the local auto assembly plants. After the assembly plants were fully staffed, employment in the sector continued to rise as jobs migrated into the area with suppliers relocating to serve the new assembly facilities.¹

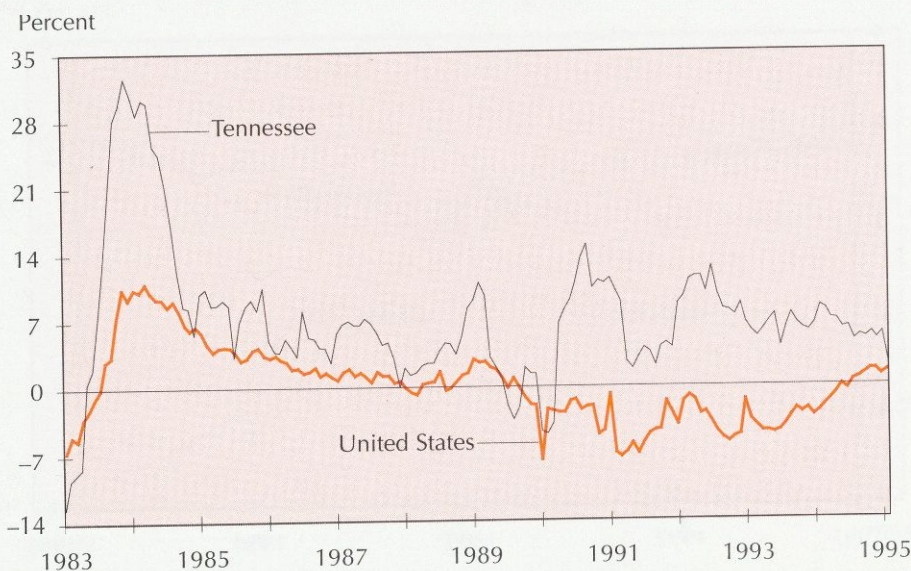
Underlying this discussion, then, is the idea that thinking about the Southeast, or, for that matter, any other region, as a small open economy is a reasonable approach. The notion is quite appealing because many theoretical aspects of a small open economy, which can be thought of as directly analogous to a perfectly competitive firm, except on a larger scale, are quite well understood. These economies are “small” in the sense that they have to take world relative prices and interest rates as given and are “open” because they have no barriers to trade with the rest of the world. Since the small open economy is essentially a price-taker in the rest of the world, trading and production patterns are governed by whatever it is that the economy happens to do well relative to the rest of the world—that is, whatever is that economy’s comparative advantage. A region’s comparative advantage therefore has a large influence on relative movements

in growth rates because as the mix of products consumed by the national economy changes over the course of a business cycle so, too, will the relative performances of the regions that have a comparative specialization in those products.

The Models

Economic Base Models. The above discussion may make it tempting to think about regional economic growth and development in terms of the so-called economic base models. The idea behind this class of models is that there is some base of economic production occurring in a particular region and this base is defined by the product being exported, or consumed outside the region. Other businesses that produce goods or services consumed strictly locally—the nonbase industries—essentially serve as support functionaries for the base businesses. The model is a convenient one because it allows expressing nonbase industry employment as a function of base industry employment; specifically, nonbase employment is seen as dependent upon performance of the base industry. Because total employment in the region is simply the sum of base and nonbase

Chart 3
Transportation Equipment Employment, Tennessee versus United States
(Monthly year-over-year rates of change)



Source: Bureau of Labor Statistics; data seasonally adjusted by the Federal Reserve Bank of Atlanta.

payrolls, changes in overall local economic conditions can be expressed as a function of changes in the base industries. It is then possible to derive estimates of parameters like "local multipliers" that purport to relate the total change in local employment that would occur as a result of adding one more job to a base industry.² For example, writing

$$\text{Nonbase Employment} = \text{Constant} + (\text{Local Multiplier} \times \text{Base Employment})$$

shows an immediate relationship between an increase in activity in the base industry and total employment in the region.

Economic base models are attractive because they can easily be related to two rather different, conventional arguments. The first is the comparative advantage idea discussed above. If a region specializes in the production of goods that are in relatively high demand (that is, if the base industries are doing well), then the region will perform well in comparison with others.

The second idea corresponds directly to the economic base logic and comes from international trade literature focused on the idea of export-led growth. This literature looks at developing economies and argues that overall domestic economic development can be fueled by exports. The policy conclusion is that developing nations should engage in policies that promote exports because general economic development will follow "export" growth.³ The conclusion is the same, although on a different scale, as that of the economic base literature, which perceives development as flowing from the "export" of goods manufactured locally.

Critics of the economic base idea have identified serious problems within the model.⁴ Of course, there is no denying that a sudden surge in demand for products produced regionally will have immediately positive growth consequences for that region. This predictability is strictly short-term, however, brought about by the immediate immobility of plant and equipment, and, to a lesser extent, population.

Unfortunately, this temporary result is of little use in formulating longer-term plans. Any exogenous shift in local income will have the same effect: an increase in local government spending, an increase in investment in the area, or even a change in the consumption and savings patterns of the local population will have similar consequences. The easy identification of changes in economic conditions in the so-called export industries does not necessarily make those changes any more significant for the local economy than

changes in the other, in some cases less easily identifiable, sources of regional income.

As Andrew C. Krikelas has observed, even recent research attempts at improving economic base models "do nothing to broaden the economic base paradigm's focus on the demand side of the regional growth equation. Past research has clearly indicated that economic base models that fail to account for important supply-side factors and constraints do not perform as well as models that try to incorporate such relationships" (1992, 26). That is, although economic base models may provide some understanding of short-run regional fluctuations, they cannot speak to the larger issues of why regions grow over a longer period of time in which movements of capital and people into or out of the region determine ultimate levels of economic development.

This problem is analogous to that of the export-led growth literature that has evolved in the field of development economics. As noted above, proponents of export-led growth argue that economic development of a country can be enhanced by fostering export industries, a point that is undeniable for the short run. Income in a region or country is defined as the sum of personal consumption, investment, government consumption, and net exports. Thus, by definition, if all other things are held constant and exports increase, then income must increase by the same amount. For relatively undeveloped areas, the notion of export-led growth may be appealing because of the difficulty in generating increases in domestic consumption, investment, or government spending in an otherwise poor area. It is not clear, however, how effective such a policy is for long-term economic development.

As Edmund Sheehy (1990, 1992, 1993) has pointed out, simply testing that increasing one component of income results in increases to total income is meaningless for thinking about appropriate development policies; export growth, like growth in any other sector, must, by definition, result in income growth. Sheehy showed that the notion that exports can be central to overall economic development is identical to claiming that resources devoted to the export production sector are more productive than resources concentrated elsewhere or that the exports themselves are a factor in the production of other goods. Testing this proposition across a number of developing economies, he found no support for the hypothesis.

The policy consequences of these shortcomings are clear: economic base models are useful short-run forecasting devices, but they offer little guidance in the formulation of policy appropriate to a time frame in which labor and capital can move.

Convergence Models. Another way of thinking about regional economic growth revolves around the idea of economic convergence. Intuitively, the convergence idea is simple: areas that have, say, low wages will grow relatively rapidly because low production costs will attract firms. Eventually enough firms will move into the area to begin driving up the wage rate (or whatever low-priced element is peculiar to the locale). Firms will continue moving until the price of the wage rate has become so close in price to that elsewhere in the economy that the advantage is lost, additional firms no longer have a reason for moving, and the differential rate of growth is eliminated.

Similar arguments are frequently offered to explain the South's rapid growth. The region's cheap labor, so

Structuralism suggests that sustained real growth differentials can be explained by real, legal, or social institutions or structures.

the reasoning goes, attracts employers at a rate in excess of the rest of the country.

The convergence model offers a plausible rationale for rapid growth. It is worth considering whether the equilibrating process that eventually results in the subsiding of growth spurts may be either a long-run phenomenon or something insignificant enough that local planners can ignore it. Theory and empirical evidence on the convergence hypothesis both seem to support this view.

The problem plaguing convergence theory is that there are two very different meanings associated with the term *growth*. Consider income: total regional income may grow relative to the rest of the economy simply because the region is adding jobs at a faster rate. Thus measured, state income, state tax revenue, gross state product, or whatever aggregate measure of income is applied may be increasing at some rate that can be compared with measures from other regions or parts of other economies. The fact that regional income may be growing according to these measures

does not necessarily mean that incomes for individuals within that region are growing, though; individual—per capita—income may or may not be changing. The difference between aggregate and individual income growth is accommodated by changes in the total work force. The South, for example, has been adding jobs at a rate faster than the rest of the nation and thus in some sense its income is growing relatively fast, yet average per capita incomes in most of the region are still below the national average.⁵

Further complicating the income story, and setting the stage for thinking about sustained regional growth differentials, is the distinction that must be made between real and nominal levels of income. Nominal income is the dollar amount that workers are paid. Real income is the quantity of goods and services that the quantity of nominal income can buy. It is real income, or more specifically the pleasure (or, more formally, the “utility”) received from its consumption, that motivates people to work. If everything cost the same everywhere in an economy (and all other amenities were equal, too), then differences in nominal incomes would translate into differences in real incomes and thus in real levels of utility associated with doing the same job in different locations. The implications of this distinction are discussed below.

Another complication in the convergence story, one that relies explicitly upon the notion of utility, lies in the problem of population migration. In order for people to be induced to move from one location to another, they must be able to expect that after the move they will be better off than before the move. That is, the expected utility associated with their new location must be higher than their expected utility in their present location.

Many components go into the calculation of expected utility. Wage rates are a component, as is the probability of finding a job (the product of which yields the expected wage); including the local relative price level gives the expected real wage rate for an area. Also included may be such things as the quality and quantity of public services and the taxes associated with those provisions, as well as less tangible items that would affect the quality of life associated with a particular location—weather, pollution, the attributes of the rest of the local population—and myriad other things.

On net, then, the expected utility associated with the choice of a specific location is a combination of many things, of which the nominal wage is but one, albeit quite important, part.

On the employer side, the location preference is a little more straightforward: locate where expected

long-term profits (however appropriately defined) are the highest. Obviously, this rather broadbrush approach has different implications for different types of firms. Small or personal service providers will want to locate in areas in which competition is, in their estimation, relatively light, or where the growth potential is such that future competition is expected to be relatively light. Intermediate goods manufacturers may choose to locate near major customers, either to minimize transportation and coordination costs or to take advantage of the same regional attributes that attracted their customers to the area in the first place.

One particularly interesting case is that of the manufacturer who is making a product the price of which is determined in a national market (or at least a market larger than the relevant local region). In this case, with determination of the price outside the influence of the individual firm, the firm maximizes profits by (at a first approximation) minimizing costs. That is, a firm that must use capital and labor for production, and whose cost of capital is determined in world markets, will benefit most by selecting a location offering relatively low labor costs. While these firms are interested in locations with relatively low wage bills, their workers are still interested in their total expected utility, or at least their real, as opposed to nominal, wage.

This dynamic sets up an interesting engine for regional growth, discussed in detail by Stacy E. Kottman (1992). Suppose a region has a relatively low cost of living, a high quality of life, or some specific attribute that just makes the place a good one in which to live. Firms in the area may pay a lower-than-average nominal wage while implicitly offering a higher-than-average real wage (a higher expected utility). That is, the firms pay a lower overall bill for their workers, while workers receive a higher overall rate of real compensation for their work.

This situation is relatively pleasant—at least from a growth perspective. Firms of the sort favored by the economic or industrial base advocates discussed above will locate in the region because simply by doing so they can increase their profitability. Employees will tend to migrate into the area because they will be better off in terms of their real wages than if they migrate to any other place. The area will tend to grow in terms of both labor and capital.

The critical element in this story is the notion that real wages may have, more or less, already converged, and thus the observed differences in nominal incomes simply reflect regional differences in amenities and the cost of living. This convergence to income differentials that simply compensate for regional cost of liv-

ing differences is called “conditional convergence,” a concept that has some empirical support.⁶

The convergence model offers more in terms of thinking about policies related to the long-run influences of growth than the economic base models, particularly since convergence is explicitly a long-run dynamic process. Real income differentials ultimately will not last. Indeed, with some reason to believe that real income differentials have already achieved conditional convergence, the next step is to ask what it would take to force up regional costs of employment to the point that nominal wages would no longer attract capital. It is in the problem of determining the level and changes in the level of these costs that structuralist theory is helpful.

Structuralist Models. Edmund S. Phelps (1994) brought together a number of related strands of thinking and produced an interesting general equilibrium approach to the problem of sustained differentials in regional economic growth.⁷ Phelps’s work attempts to model why economies, or segments of economies, seem to get stuck in a long-term slump. His well-specified model provides a serious understanding of capital flows, interest rates, assets, goods, and labor market behavior, all in a general equilibrium framework. A major finding is that sustained slumps must be supported by some sort of institutional structure (however broadly defined) that in some way hinders the economy’s achieving the standard neoclassical results (that is, a tendency toward full employment and convergence in income levels and ultimately growth rates). In other words, structuralism suggests that sustained real growth differentials can be explained by real, legal, or social institutions or structures.

Of major interest here is a discussion of the labor market. Phelps adopts a “quitting” or “shirking” model approach to unemployment. The idea is to use a model that is capable of generating involuntary unemployment as an equilibrium outcome (as opposed to, say, simple supply and demand, where the equilibrium outcome consists of a wage rate that equates the quantity of labor supplied with the quantity of labor demanded. Workers not employed are unemployed “voluntarily” in the sense that their inability to find jobs stems from their requiring too high a wage rather than a lack of available jobs).

The quitting model begins with the outcome of a simple supply-and-demand model, where there is some equilibrium wage rate that results in an equal quantity of labor demanded and supplied. At that wage rate, however, workers can move from firm to firm without penalty, able immediately to find other work

at the prevailing wage. This movement of workers is problematic for firms, which suffer costs associated with simply administering the turnover in addition to the potential costs of devoting resources to the training or at least orientation of new workers. So the firm has an incentive to offer a wage rate slightly above the prevailing wage rate so that their workers would face a penalty—having to take a lower wage—if they were to leave. All firms, however, face a similar problem, so firms collectively end up making a wage offer that is above the standard equilibrium. Since this is the wage that prevails in the labor market, firms offset it by demanding a somewhat smaller quantity of labor and workers offer a somewhat larger quantity of labor. The result is unemployment (see Chart 4).⁸

This involuntary unemployment is an equilibrium result. While individual firms no longer are offering a wage differential, the workers still have an incentive to stay with the firm: the worker would face a loss by having to spend some time being involuntarily unemployed after separation from the current job.

The structuralist approach asks which of the many possible factors would go into determining the size of this differential. On the worker side, the more unpleasant unemployment seems, the more unemployment will serve as a penalty and the lower the differential will have to be. Thus, income transfer or maintenance

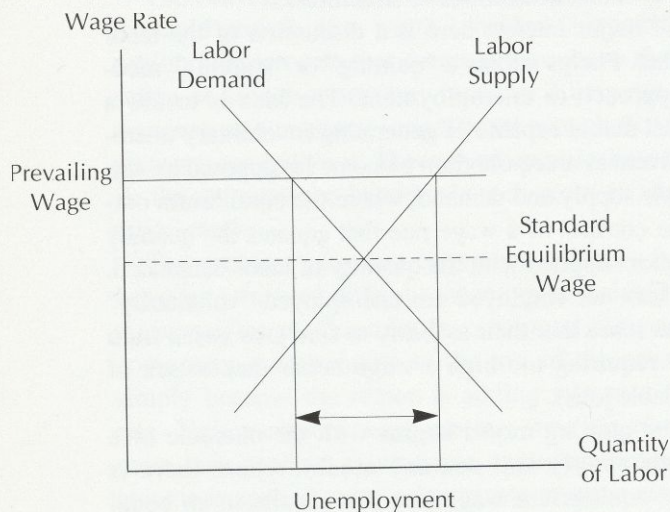
schemes, especially those focused on mitigating the difficulties associated with unemployment (such as some welfare or unemployment insurance schemes), serve to complicate the problem. For firms, policies that increase the cost of employment, in particular anything that drives a wedge between what the employer must pay to obtain the services of a worker and what that worker receives from the firm, will, again, exacerbate unemployment. Policies such as payroll taxes and some worker's compensation premiums have this effect.

Together, the structuralist model and empirical tests of the convergence hypothesis offer insight into the Southeast's recent strengths and future prospects. Relatively rapid and sustained regional economic growth, to oversimplify, will occur in a place that is relatively better for living and doing business: Workers will be attracted to areas that offer high expected utility—some combination of a high real wage, available jobs, and other quality- versus cost-of-life issues. Firms will be attracted to areas in which the cost of employment is relatively low—a low cost of living that permits the firm to offer a higher real wage while paying a lower nominal wage, and low costs of employment that minimize the difference between what firms pay for workers and what the workers ultimately receive.

This approach provides a systematic way of thinking about sustainable regional growth differentials. For example, one condition for being able to offer a high real wage yet pay a low wage bill is for the regional cost of living to be relatively low. ACCRA (1995) (formerly the American Chamber of Commerce Researchers Association) publishes a relative cost of living index comparing a number of metropolitan areas in terms of a consumption bundle designed to reflect a middle-management standard of living. Southeastern states consistently have average costs of living below national levels, with the exception of some metro areas in Florida and Louisiana. At the same time, areas from which the Southeast has specifically gained employers, in particular the Northeast, have average costs notably above national figures.

For firms, there is no analogous survey of employment costs. There is anecdotal evidence, however, suggesting that the Southeast is a relatively inexpensive place to do business. In particular, the region offers low marginal state tax rates and is perceived as having "probusiness" state regulatory environments. Just as importantly, the current high rate of growth enhances the region's attractiveness to suppliers of firms located in the area, and it benefits from the agglomeration effects. That is, for products or services for which

Chart 4
The "Quitting" or "Shirking" Model



costs may decline by proximity to their consumers, locating near the customers cuts costs. The migration of auto component manufacturers to Tennessee therefore is not surprising given the state's position as the geographic center of the new southern auto assembly plants.

In sum, the structuralist approach suggests a number of individual reasons—many of which are policy driven—for the Southeast's relatively rapid growth. Taken together, they form an economic structure that may attract both employers and employees to the region at a disproportionate rate for some time to come.

Conclusion

Regional rates of growth concern anyone interested in long-term economic planning. The national economy's overall performance will have an enormous impact on variations in local conditions, but some areas will always outperform others. Having systematic ways for thinking about regional growth disparities is important for policymakers and planners in both government and business.

The models discussed in this article provide the most common approaches to thinking about why re-

gions grow, and they have many more commonalities than differences. The emphasis is always on a region's comparative advantages, although defining those advantages provokes debate: comparative advantages are static only in the case of natural resources, and even then resources may change over time; otherwise, advantages depend on technologies, tastes, and institutions, all of which are constantly changing. The economic base models are the oldest, and their use is widespread; their essentially static nature provides considerable reason to question their usefulness for anything other than very short-term analysis, however. The convergence literature is attractive from both a theoretical and empirical viewpoint but is not concerned with the underlying causes of the fundamental disparities characterizing the converging economies. Indeed, this view assumes that growth eventually forces the regional differences to narrow, to the point that the growth differentials disappear. The structuralist approach addresses the root causes of differential growth rates and, in contrast to convergence theory, finds that the differences may not diminish simply as a consequence of the growth differentials they engender. Thus, although relatively new, the structuralist model appears to hold considerable promise as a way of thinking about continuing long-term economic slumps or booms.

Notes

1. This reasoning can be used to make the argument that the real winner in the Mercedes plant deal was not Alabama, which ultimately won the Mercedes assembly deal, but rather Tennessee which, as a consequence of Mercedes's decision, now has a very strong claim to being the geographic hub of the new southern auto industry because it is the center of assembly plants in Georgia, Alabama, Tennessee, South Carolina, Kentucky, and Ohio.
2. For a detailed discussion, see Krikelas (1992).
3. An excellent critique of the export-led growth literature can be found in the work of Sheehy (1990, 1992, 1993).
4. These are discussed at some length by Krikelas (1992).
5. In the 1960s and 1970s, however, per capita incomes in the South did move substantially toward the national average.
6. The issue turns on whether changes in regional income differentials persist over time or, more formally, whether regional income differentials contain a unit root. Carlino and Mills (1993) provide an excellent presentation of a battery of tests for persistence and uniformly find reasonable support for its existence.
7. See Cunningham (1994) for a review of Phelps (1994). Also see an excellent review by Woodford (1994).
8. Many stories could fit the basic model. For example, consider shirking instead of quitting: in a standard supply-and-demand model the worker would face no penalty for losing a job because other jobs are available at the same wage rate. Thus, firms would want to offer a slightly higher wage to provide some incentive for employees not to shirk their work responsibilities and lose their jobs.

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FYI

Commercial Bank Profits in 1994

Lynn W. Woosley and James D. Baer

Commercial banks enjoyed another highly profitable year in 1994, continuing the trend that began in 1992. Net income reached a new record—\$44.5 billion, up from the previous year's record \$43.0 billion. Further widening of net interest margins, adjusted for risk and nontaxable earnings, drove earnings growth. These wider margins resulted primarily from continued declines in loan-loss provisions. (Tables 1 and 2 provide interest margin and loan-loss data on the nation's banks for 1990-94). Banks in the Southeast again outperformed the national average.¹ (See Box 1 for a discussion of bank performance measures.)

Favorable conditions in the nation's economy stimulated loan demand and helped curtail loan losses. These conditions, added to several years of working out the industry's problems, also helped improve the health of the banking industry. Only eleven banks failed in 1994, compared with forty-two in 1993. The number of banks classified as "problem institutions" by the FDIC also fell, from 426 in 1993 to 247 in 1994. The assets held by problem institutions fell even more drastically, by 86.4 percent, from \$242 billion in 1993 to only \$33 billion in 1994 (FDIC 1994, 4). Strength in the southeastern economy helped avoid bank failures in the region; no southeastern commercial banks failed in 1993 or 1994.

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Bank Profitability Measures

The two primary profitability measures, return on assets (ROA) and return on equity (ROE), remained strong in 1994, but both were down slightly from 1993 levels (see Tables 3 and 4). Although net income increased by 3.5 percent in 1994, both assets and equity grew faster (by 8.1 percent and 5.2 percent, respectively), causing profitability measures to fall somewhat. (Part of the asset and equity growth was accounted for by changes in accounting rules. These are discussed below.) Banks' ROA dropped less than 5 percent to 1.17 percent in 1994 (from 1.23 percent in 1993), while ROE fell by about the same proportion (from 15.78 percent in 1993) to 14.90 percent. The decline in overall ROA resulted primarily from a dip in the profitability of the nation's largest institutions (those with assets exceeding \$1 billion).² The smallest banks (those with assets less than \$100 million) also registered slight declines in profitability as measured by ROA. Banks with assets between \$100 million and \$1 billion generally improved their ROA in 1994.³

Banks managed to slightly improve their adjusted net interest margins in 1994 from a strong 1993 level. Although interest income increased, interest-earning assets grew more, causing a decline in interest revenue as a percentage of interest-earning assets (gross interest return) (see Table 7). Together, a modest decline in interest expense per dollar of interest-earning assets and in loan-loss expense more than compensated for the diminished gross interest return (see Table 8).

Intermediation. The moderate economic expansion throughout 1994 stimulated loan demand, resulting in a 9.85 percent increase in net loans and leases outstanding.⁴ Adjusted net interest margins were little changed, rising only 0.05 to 4.07 from the 1993 level. This small change fails to reflect the significant developments among the components that aggregate to net interest margins.

The 1994 data reveal proportionally less growth in total interest revenue (4.19 percent) than in interest-earning assets, resulting in a 3.27 percent drop in the ratio of interest revenue to interest-earning assets. This drop seems to present a paradox of growth in interest revenues lagging behind growth in interest-earning assets during a period of rising interest rates. This phenomenon applies particularly to the largest class of banks, which strongly influence the figures for all banks. For these larger banks the paradox can be explained by certain accounting changes regarding the

treatment of securities and derivative assets (detailed in the section on balance-sheet developments below). The net effect of these accounting changes was to cause a one-time increase in the measured interest-earning asset base (including all trading account assets) for those banks that deal in derivatives. Virtually all of these are in the large bank category. Inflation of the interest-earning asset base is estimated to have caused a 29 basis point decrease in interest revenue as a percentage of interest-earning assets. This decrease accounts for 78 percent of the drop in this statistic.⁵ Note that a decrease similar to this 29 basis point decline also applies to interest expense as a percentage of interest-earning assets for the large banks. However, as loan demand expanded, these banks chose to fund a portion of new loans by seeking additional funds from more expensive sources, pushing expenses up and partially offsetting the interest expense ratio drop caused by asset inflation. This behavior explains a fall of only 16 basis points in the large bank interest expense ratio from 3.58 to 3.42.⁶

Interest expenses for all banks rose proportionally less than net interest-earning assets, resulting in a small decrease of 0.10 in interest expense as a percentage of interest-earning assets. Unadjusted for loan-loss expenses, the interest margin would have fallen from 4.55 in 1993 to 4.39 in 1994. Loan-loss reserves were significantly reduced in 1994, largely offsetting the reported decline in interest revenue as a percentage of interest-earning assets.

Provisions for Loan and Lease Losses. Bank credit quality continued to improve in 1994 as provisions for loan losses as a percentage of interest-earning assets declined by 39.6 percent from the 1993 level. Non-current loans declined every quarter in 1994, and bank holdings of foreclosed property fell by \$6.7 billion during the year.⁷ Net loan charge-offs for 1994 fell to their lowest level since 1984 (FDIC 1994, 2). Table 2 shows that commercial banks' loan-loss provisions as a percentage of interest-earning assets fell to 0.32 percent (from 0.53 percent in 1993 and 0.88 percent in 1992). In spite of declining loan-loss provisions, the ratio of reserves to noncurrent loans rose to the highest level ever reported.⁸ W. Scott Frame and Christopher L. Holder (1994) have identified three factors contributing to improving credit quality in recent years: good general economic conditions, the disappearance of weak institutions by merger or failure, and purging of problem loans from bank portfolios in recent years. In short, the general condition of the banking industry has improved, allowing banks to reduce their loan-loss allowances and, in some cases, to recapture some of their loan-loss reserves.

Although banks in nearly every size category enjoyed reductions in loan-loss expenses, both the size of the declines and the level of loan-loss provisions varied greatly among the size classes. While the nation's largest banks still set aside the greatest percentage of their assets for loan losses, they again posted the most impressive decline in loan-loss expenses per dollar of assets. These declines account for the bulk of the 1994 reduction (in dollar terms) in all-bank loan-loss expenses. The percentage of loans at the largest banks classified as nonperforming shrank by more than 40 percent.⁹ However, the largest banks still have a higher proportion of nonperforming loans than other banks (see Table 9).

Unlike their larger counterparts, the nation's smallest institutions posted increases in loan-loss expenses in 1994. The authors' telephone conversations with officers of community and independent bankers associations identified several factors potentially contributing to this difference. First, small banks frequently have less geographic and industrial diversity in their loan portfolios, exposing them to greater risk in local economic shocks. Second, small banks may be taking advantage of the near record earnings in 1994 to build reserves without excessively reducing dividends or earnings per share. Third, management at the smallest banks may face less shareholder pressure to maintain and increase ROA and ROE. Managers of small banks also suggested that they may be less inclined than their counterparts at larger banks to manage loan-loss reserves in order to smooth profitability. Finally, many of the smallest banks did not build the high levels of reserves observed at the larger banks in previous years. As their loans increase, these small banks must continue to add to their reserves to maintain appropriate levels.

Noninterest Expenses and Revenues. In 1994 employment expenses were relatively stable but slightly higher for nearly every size class. The smallest banks in particular bear high and increasing employment expenses as a percentage of total assets. Occupancy expenses were also higher for most size classes (\$50 million–\$1 billion in assets). However, overall noninterest expense as a percentage of assets declined, reflecting, mainly, rapid asset growth (Table 10).

Noninterest income as a percentage of total assets decreased slightly in 1994, driven by declines at banks with total assets exceeding \$500 million (Table 11). For smaller banks, noninterest income as a percentage of total assets increased. Banks of all sizes, on average, experienced small losses on securities activities, reversing the small gains of each of the previous four years (see Table 12).

Balance-Sheet Developments. The aggregate commercial bank balance sheet shows that banks experienced an 8.1 percent increase in total assets in 1994. A significant part of this increase was due to the changes caused by regulatory adoption of Financial Accounting Standards Board Interpretation 39 (FASBI 39).¹⁰ FASBI 39 limited banks' ability to net the value of off-balance-sheet derivative contracts, thus causing a one-time increase in reported assets (see Table 6) (FDIC 1994, 2). About one-third of the 1994 reported increase in total assets was attributable to the effects of FASBI 39. These increases are, in turn, responsible for roughly half the observed decline in the average ROA (William B. English and Brian K. Reid 1995).

The aggregate balance sheet for year-end 1994 indicates that the dollar amount of total equity capital rose by 5.2 percent. However, capital as a percentage of total assets fell from 8.0 percent in 1993 to 7.8 percent in 1994 as a result of the rapid asset growth generated by rising loans and accounting changes.

The aggregate dollar volume of securities held declined slightly from December 31, 1993, to December 31, 1994. However, reported securities holdings as a percentage of total assets declined by 8.9 percent. Declining securities holdings resulted in part from banks' selling securities, and not replacing maturing securities, to fund loan demand. To the extent that holdings of Treasury securities were reduced to fund increased loan demand, banks have added to the risk of their total assets while increasing their margins.

Another factor in the reduction in securities was the adoption of Statement of Financial Accounting Standards Number 115 (SFAS 115), which resulted in banks' marking a much larger share of their securities to market.¹¹ SFAS 115 caused banks to reduce their reported securities holdings by about \$11.5 billion and their reported equity capital by approximately \$7.9 billion (FDIC 1994, 2). Declining Treasury prices (resulting from rising interest rates) and securities holdings were responsible for the remaining reductions in reported securities holdings. (Commercial bank balance-sheet developments for U.S. and southeastern banks during 1994 are shown in Box 2.)

Banks in the Southeast

Banks in the Southeast exceeded nationwide profitability figures. The region's ROA and ROE were 1.29 percent and 15.41 percent, respectively, compared with a 1.17 percent ROA and a 14.90 percent

ROE nationally (see Tables 13-16). Nevertheless, all of the Sixth Federal Reserve District states except Florida and Georgia showed a slight decline in both ROA and ROE from 1993 levels. Mississippi and Georgia banks remained below national ROE levels. Even so, twenty-seven of the one hundred most profitable large community banks and twelve of the one hundred most profitable small community banks were headquartered in Sixth Federal Reserve District states.¹²

Florida banks posted significant increases in both ROA and ROE, with ROA rising to 1.29 percent and ROE increasing to 16.64 percent, up 12.2 percent and 8.0 percent, respectively, from 1993. The improvement in Florida's profitability was primarily the result of an increase in the adjusted net interest margin from 4.52 percent in 1993 to 4.58 percent in 1994. For 1994 the national average was 4.07 percent and the southeastern average was 4.53 percent. In addition, Florida banks' total noninterest expense was only 3.39 percent of total assets, well below national and southeastern averages. This outcome was primarily the result of lower-than-average wage and salary expenses.

Louisiana banks also did well. Fifteen of the one hundred most profitable large community banks in the nation make Louisiana their home, more than any other state except Texas (Terrance O'Hara 1995). However, Louisiana showed a marked decline in both profitability measures from 1993 levels. Even with the decline, Louisiana banks led the region in ROA performance and were a close second to Florida in ROE achievement. During the recent bad years in Louisiana, bankers have exercised more conservative lending practices and rid their loan portfolios of nonperforming and questionable loans. As Louisiana's economy has improved, banks have rapidly increased their lending in all categories without significant increases in nonperforming loans. Much of the loan gains are in retail lending, which generally offers higher margins than commercial lending. Noninterest expenses, primarily wage and premises expenses, have been higher than average, however, keeping Louisiana's performance from reaching even better levels.¹³

Despite equaling the region's banks in ROA, Georgia banks remained below regional and national averages in ROE in 1994. Georgia's lower ROE performance is related to higher levels of equity capital. A contributing factor may be the state's restrictive branching laws, which have led to a disproportionate number of small, more highly capitalized banks.

The average adjusted net interest margin of banks in the Southeast was subject to the same influences that produced a stable margin for banks in the nation

as a whole. Despite these factors, southeastern interest revenues and expenses both rose as a percentage of assets. This development may be due to a limited effect of FASBI 39 on banks in the region. Lower loan-loss expenses, used as a proxy adjustment for risk, allowed the margin to remain unchanged. Still, banks in the Southeast continued to earn a higher margin than the overall average for the nation (see Tables 17-22).

Net loans grew by 13.3 percent in the Southeast, compared with 9.9 percent nationally. Southeastern banks also did better than banks in the nation as a whole in deposit gathering. Total domestic deposits increased by 6.0 percent, while they rose only 0.6 percent nationwide. In addition, southeastern banks reduced their securities holdings by 2.7 percent, compared with the national decline of 1.7 percent. As with banks in the rest of the nation, part of this decline was attributable to the substitution of loans for securities.

The level of loan-loss provisions was the same or lower in the Southeast (with the exception of Georgia) than in the nation, and every southeastern state except Louisiana posted a decline in loan losses as a percentage of interest-earning assets (see Tables 23 and 24). Similarly, nonperforming loans (as a percentage of total loans) were lower for Sixth District banks than for the nation's (Tables 25-27). Louisiana banks had a negative loan-loss provision for the second consecutive year because they recovered from high loan-loss reserves remaining from the early 1990s. These recoveries significantly boosted their earnings performance in 1993 and 1994.

As might be expected, given the historically low level of international activity by southeastern banks, Sixth District banks were not hit as heavily as the large money center and multinational banks by declining income from foreign exchange trading and other foreign transactions. In addition, the region's banks achieved increases in fee income much larger than national gains.¹⁴ However, noninterest income as a percentage of total assets decreased in 1994 as interest-earning assets grew rapidly.

Conclusion and Outlook for 1995

Commercial banks had record net income in 1994, but their ROA and ROE were slightly lower than those of 1993. The favorable economic conditions allowing such profitability are a continuation of the trend that began in 1992. Continued declines in loan-loss provisions were the primary catalysts for increases in ad-

justed net interest margins. Lower noninterest expense ratios and higher interest-earning assets also contributed to 1994's performance. Yet asset and equity growth exceeded earnings growth, and ROA and ROE slipped.

In 1995, levels of net income margins, ROA, and ROE should remain near historic highs. Major accounting changes are unlikely to influence reported assets. A substantial reduction in FDIC premiums will also have a positive impact on earnings ratios. The exact benefit to the bottom line will depend on the timing and amount of the premium refunds as well as the outcome of discussions on differences in deposit insurance premiums for thrifts and banks.¹⁵ Other potential influences to banks' 1995 performance include

some deceleration in economic growth and its consequences for credit quality and loan demand. If there is an economic "soft landing," banks will probably have relatively stable earnings, although interest income will be somewhat lower as loan demand returns to normal levels. Lower loan demand would reduce interest revenue, in turn, possibly lowering net interest margins and net income. It appears, however, that banks are well covered by their loan-loss reserves for 1995, so the immediate impact of any decline in credit quality should be small. In short, 1995 earnings should be solid, although profitability may be somewhat lower than in 1994.

Box 1 Banking Performance Measures

The three primary measures presented in this article to gauge bank performance are adjusted net interest margin, return on assets, and return on equity. Adjusted net interest margin is simply the difference between a bank's interest income (adjusted for tax-exempt securities earnings and loan-loss provisions) and interest expenses, divided by average interest-earning assets. This measure is similar to a business's gross profit margin except that sales of fee-based services by banks are not included.¹ Interest revenue from tax-exempt securities is adjusted upward by the bank's marginal tax rate to avoid penalizing institutions with substantial state and local securities portfolios, which earn less interest but reduce tax burdens. Loan-loss expenses are substituted as a rough measure of risk to place banks that make lower-risk loans at lower interest rates on a more equal basis with institutions whose higher-risk loans earn higher rates.

Return on assets, or the ratio of net income to average assets, demonstrates how profitably a bank's management is using the firm's assets. In contrast, return on equity, or the ratio of net income to average equity, tells a bank's shareholders how much the institution is earning on the book value of their investments. Analysts looking to compare profitability (while ignoring differences in equity capital ratios) generally focus on ROA, while those wishing to focus on returns to shareholders look at ROE.

The three measures are defined as follows:

Adjusted Net Interest Margin =

$$\frac{\text{Adjusted Interest Revenues} - \text{Interest Expense}}{\text{Average Interest-Earning Assets}}$$

Return on Assets =

$$\frac{\text{Net Income}}{\text{Average Consolidated Assets}}$$

Return on Equity =

$$\frac{\text{Net Income}}{\text{Average Equity Capital}}$$

Average interest-earning assets, and equity capital are derived by averaging beginning-, middle-, and end-of-year balance-sheet figures.

The bank data used in this article were taken from the federal bank regulators' quarterly Report of Condition and Income (Call Report) for insured domestic commercial banks. The sample consists of all banks that had the same identification number at the beginning and the end of the year. The number of banks in the 1994 sample is 10,384, a 4.6 percent decline from 1993. The number of banks in the six-state region defined as the Southeast was 1,496, a 4.4 percent decline from 1993.

Note

1. Fee-based (noninterest) income is derived from deposit service charges, charges for letters of credit, and other bank-related activities.

Box 2
Balance Sheet for Commercial Banks
(Millions of dollars)

	Dec. 31, 1994	Dec. 31, 1993	Percentage Change
U.S. Commercial Banks			
Assets			
Cash and balances due from depository institutions			
Noninterest-bearing balances and currency and coin	208,106.4	188,134.9	10.6
Interest-bearing balances	94,264.0	83,799.2	12.5
Securities	813,878.0	828,032.9	-1.7
Federal funds sold	128,961.2	123,182.6	4.7
Securities purchased under agreements to resell	19,592.2	27,120.6	-27.8
Loans and lease financing receivables			
Loans and leases net of unearned income	2,344,209.6	2,139,326.4	9.6
Less allowance for loan and lease losses	51,712.1	52,400.8	-1.3
Less allocated transfer risk reserve	149.8	174.1	-14.0
Loans and leases, net of above items	2,292,347.6	2,086,751.4	9.9
Assets held in trading accounts	193,873.9	122,362.5	58.4
Premises and fixed assets	58,398.6	55,084.8	6.0
Other real estate owned	10,133.1	16,755.2	-39.5
Investments in unconsolidated subsidiaries and associated companies	3,709.7	3,592.7	3.3
Customers' liability on acceptances outstanding	13,433.8	13,306.9	1.0
Intangible assets	23,859.6	17,892.1	33.4
Other assets	124,382.7	119,021.5	4.5
Total assets	3,984,940.8	3,685,037.4	8.1
Liabilities			
Deposits			
In domestic offices	2,422,296.8	2,408,020.8	0.6
Noninterest-bearing	553,111.3	553,321.0	0.0
Interest-bearing	1,869,185.5	1,854,699.8	0.8
In foreign offices, Edge and Agreement subsidiaries, and IBFs	431,817.8	329,906.4	30.9
Noninterest-bearing	15,722.4	15,641.1	0.5
Interest-bearing	416,095.4	314,265.3	32.4
Federal funds purchased	221,394.8	177,060.3	25.0
Securities sold under agreements to repurchase	88,041.1	95,174.9	-7.5
Demand notes issued to the U.S. Treasury	15,688.4	34,951.6	-55.1
Trading liabilities	118,754.4	NA	NA
Other borrowed money	232,399.9	186,118.5	24.9
Mortgage indebtedness and obligations under capitalized leases	1,512.9	1,810.0	-16.4
Banks' liability on acceptances executed and outstanding	13,495.0	13,401.4	0.7
Subordinated notes and debentures	40,571.4	37,147.7	9.2
Other liabilities	88,544.3	106,437.6	-16.8
Total liabilities	3,674,516.8	3,390,029.2	8.4
Limited-life preferred stock and related surplus	1.8	4.9	-62.9

	Dec. 31, 1994	Dec. 31, 1993	Percentage Change
Equity Capital			
Perpetual preferred stock and related surplus	1,481.6	1,486.7	-0.3
Common stock	34,240.4	32,553.6	5.2
Surplus	135,563.7	126,153.1	7.5
Undivided profits and capital reserves	147,995.2	133,032.4	11.3
Net unrealized gain (loss) on marketable equity securities	(7,842.8)	2,906.4	169.9
Cumulative foreign currency translation adjustments	(1,015.9)	(1,128.7)	-10.0
Total equity capital	310,422.2	295,003.4	5.2
Total liabilities, limited-life preferred stock, and equity capital	3,984,940.8	3,685,037.4	8.1

Southeastern Commercial Banks

Assets			
Cash and balances due from depository institutions			
Noninterest-bearing balances and currency and coin	24,949.3	22,299.9	11.9
Interest-bearing balances	3,709.4	4,595.6	-19.3
Securities	104,789.2	107,649.5	-2.7
Federal funds sold	15,808.0	13,980.0	13.1
Securities purchased under agreements to resell	2,079.6	2,325.4	-10.6
Loans and lease financing receivables			
Loans and leases net of unearned income	275,323.2	242,919.6	13.3
Less allowance for loan and lease losses	4,928.5	4,773.7	3.2
Less allocated transfer risk reserve	0.5	14.4	-96.5
Loans and leases, net of above items	270,394.2	238,131.5	13.6
Assets held in trading accounts	655.7	1,091.0	-39.9
Premises and fixed assets	7,458.9	6,997.2	6.6
Other real estate owned	1,022.2	1,571.1	-34.9
Investments in unconsolidated subsidiaries and associated companies	131.2	139.0	-5.6
Customers' liability on acceptances outstanding	1,106.2	1,176.4	-6.0
Intangible assets	2,912.3	1,775.8	64.0
Other assets	8,587.9	7,155.1	20.0
Total assets	443,604.1	408,887.4	8.5

Liabilities			
Deposits			
In domestic offices	342,744.8	323,480.4	6.0
Noninterest-bearing	66,358.7	63,871.9	3.9
Interest-bearing	276,386.1	259,608.5	6.5
In foreign offices, Edge and Agreement subsidiaries, and IBFs	4,291.9	1,945.1	120.7
Noninterest-bearing	18.3	19.9	-8.0
Interest-bearing	4,273.6	1,925.1	122.0
Federal funds purchased	30,233.7	19,347.8	56.3
Securities sold under agreements to repurchase	10,258.2	13,543.1	-24.3

Continued on page 18

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	Dec. 31, 1994	Dec. 31, 1993	Percentage Change
Liabilities			
Demand notes issued to the U.S. Treasury	903.6	2,277.7	-60.3
Trading liabilities	100.5	NA	NA
Other borrowed money	10,132.0	6,614.2	53.2
Mortgage indebtedness and obligations under capitalized leases	131.8	112.2	17.5
Banks' liability on acceptances executed and outstanding	1,106.2	1,176.4	-6.0
Subordinated notes and debentures	1,712.6	846.5	102.3
Other liabilities	5,340.8	5,429.2	-1.6
Total liabilities	406,956.1	374,772.6	8.6
Limited-life preferred stock and related surplus	0.6	1.8	-66.7
Equity Capital			
Perpetual preferred stock and related surplus	205.3	199.1	3.1
Common stock	2,565.8	2,436.6	5.3
Surplus	16,407.9	15,035.0	9.1
Undivided profits and capital reserves	18,250.3	15,858.5	15.1
Net unrealized gain (loss) on marketable equity securities	(781.9)	583.8	-233.9
Cumulative foreign currency translation adjustments	0.0	0.0	0.0
Total equity capital	36,647.4	34,113.0	7.4
Total liabilities, limited-life preferred stock, and equity capital	443,604.1	408,887.4	8.5

Source: From "Consolidated Reports of Condition for Insured Commercial Banks," 1993-94, filed with each bank's respective regulator.

Table 1
Adjusted Net Interest Margin
(Insured commercial banks by consolidated assets)

Year	All Banks	\$0-\$25 million	\$25-\$50 million	\$50-\$100 million	\$100-\$500 million	\$500 million-\$1 billion	\$1 billion+
1994	4.07	4.70	4.76	4.74	4.69	4.72	3.85
1993	4.02	4.64	4.69	4.61	4.55	4.47	3.80
1992	3.80	4.64	4.69	4.64	4.50	4.31	3.48
1991	3.14	4.31	4.29	4.25	4.14	3.65	2.72
1990	3.06	4.26	4.23	4.23	4.11	3.95	2.59

Source: Figures in all tables have been computed by the Federal Reserve Bank of Atlanta from data in "Consolidated Reports of Condition for Insured Commercial Banks" and "Consolidated Reports of Income for Insured Commercial Banks," 1990-94, filed with each bank's respective regulator.

Table 2
Loan-Loss Expense as a Percentage of Interest-Earning Assets
(Insured commercial banks by consolidated assets)

Year	All Banks	\$0-\$25 million	\$25-\$50 million	\$50-\$100 million	\$100-\$500 million	\$500 million-\$1 billion	\$1 billion+
1994	0.32	0.19	0.16	0.19	0.23	0.33	0.35
1993	0.53	0.18	0.22	0.26	0.34	0.50	0.61
1992	0.88	0.39	0.35	0.40	0.54	0.78	1.04
1991	1.17	0.42	0.47	0.50	0.65	1.09	1.40
1990	1.11	0.50	0.53	0.53	0.67	1.00	1.30

Table 3
Percentage Return on Assets
(Insured commercial banks by consolidated assets)

Year	All Banks	\$0-\$25 million	\$25-\$50 million	\$50-\$100 million	\$100-\$500 million	\$500 million-\$1 billion	\$1 billion+
1994	1.17	1.04	1.12	1.16	1.22	1.19	1.17
1993	1.23	1.09	1.16	1.17	1.20	1.14	1.25
1992	0.95	0.93	1.02	1.08	1.05	0.94	0.92
1991	0.54	0.62	0.72	0.83	0.83	0.54	0.44
1990	0.49	0.58	0.67	0.79	0.78	0.76	0.38

Table 4
Percentage Return on Equity
(Insured commercial banks by consolidated assets)

Year	All Banks	\$0-\$25 million	\$25-\$50 million	\$50-\$100 million	\$100-\$500 million	\$500 million-\$1 billion	\$1 billion+
1994	14.90	9.73	11.18	12.01	13.49	14.19	15.73
1993	15.78	10.38	11.82	12.40	13.77	14.06	16.98
1992	13.24	9.25	10.82	11.93	12.61	12.52	13.86
1991	8.05	6.24	7.86	9.40	10.51	7.50	7.35
1990	7.64	5.85	7.43	9.01	9.95	10.25	6.68

Table 5
Number of Banks by Asset Size
(Insured commercial banks)

Year	All Banks	\$0-\$25 million	\$25-\$50 million	\$50-\$100 million	\$100-\$500 million	\$500 million-\$1 billion	\$1 billion+
1994	10,384	1,993	2,585	2,634	2,534	251	387
1993	10,882	2,188	2,775	2,770	2,527	243	379
1992	11,361	2,511	2,933	2,774	2,518	250	375
1991	11,775	2,837	3,090	2,750	2,476	257	365
1990	12,134	3,189	3,139	2,737	2,449	249	371

Table 6
Total Consolidated Assets*
(Insured commercial banks)

Year	All Banks	\$0-\$25 million	\$25-\$50 million	\$50-\$100 million	\$100-\$500 million	\$500 million-\$1 billion	\$1 billion+
1994	3,773	32	93	183	482	167	2,816
1993	3,521	35	98	192	483	165	2,549
1992	3,344	41	103	190	481	170	2,359
1991	3,318	44	108	188	472	174	2,332
1990	3,292	49	110	184	459	163	2,327

*Amounts in billions of dollars.

Table 7
Tax-Equivalent Interest Revenue as a Percentage of Interest-Earning Assets
(Insured commercial banks by consolidated assets)

Year	All Banks	\$0-\$25 million	\$25-\$50 million	\$50-\$100 million	\$100-\$500 million	\$500 million-\$1 billion	\$1 billion+
1994	7.68	7.79	7.83	7.84	7.81	7.93	7.63
1993	7.94	7.82	7.91	7.84	7.79	7.76	8.00
1992	8.81	8.94	8.85	8.85	8.76	8.62	8.82
1991	10.03	9.97	10.06	10.05	10.07	9.94	10.03
1990	11.26	10.60	10.72	10.71	10.82	11.18	11.44

Table 8
Interest Expense as a Percentage of Interest-Earning Assets
(Insured commercial banks by consolidated assets)

Year	All Banks	\$0-\$25 million	\$25-\$50 million	\$50-\$100 million	\$100-\$500 million	\$500 million-\$1 billion	\$1 billion+
1994	3.29	2.89	2.90	2.92	2.89	2.89	3.42
1993	3.39	3.00	2.99	2.97	2.90	2.80	3.58
1992	4.13	3.90	3.81	3.81	3.73	3.53	4.30
1991	5.72	5.23	5.30	5.30	5.28	5.18	5.92
1990	7.09	5.85	5.96	5.96	6.03	6.23	7.55

Table 9
Nonperforming Loans as a Percentage of Total Loans
(Insured commercial banks by consolidated assets)

Year	All Banks	\$0-\$25 million	\$25-\$50 million	\$50-\$100 million	\$100-\$500 million	\$500 million-\$1 billion	\$1 billion+
1994	1.54	1.30	1.17	1.20	1.27	1.33	1.63
1993	2.44	1.55	1.43	1.49	1.62	1.82	2.74
1992	3.34	2.02	1.80	1.75	1.96	2.31	3.87
1991	3.76	2.12	2.08	2.03	2.19	2.72	4.34
1990	2.71	1.88	1.80	1.68	1.70	1.91	3.07

Table 10
Total Noninterest Expense as a Percentage of Total Assets
(Insured commercial banks by consolidated assets)

Year	All Banks	\$0-\$25 million	\$25-\$50 million	\$50-\$100 million	\$100-\$500 million	\$500 million-\$1 billion	\$1 billion+
1994	3.78	3.96	3.67	3.55	3.66	3.76	3.82
1993	3.95	3.94	3.64	3.45	3.68	3.80	4.06
1992	3.91	4.06	3.57	3.44	3.61	3.73	4.03
1991	3.73	3.95	3.56	3.40	3.49	3.63	3.82
1990	3.50	3.93	3.46	3.32	3.34	3.56	3.53

Table 11
Noninterest Income as a Percentage of Total Assets
(Insured commercial banks by consolidated assets)

Year	All Banks	\$0-\$25 million	\$25-\$50 million	\$50-\$100 million	\$100-\$500 million	\$500 million-\$1 billion	\$1 billion+
1994	1.91	1.22	1.06	1.03	1.27	1.31	2.15
1993	2.02	1.21	1.02	0.93	1.24	1.39	2.34
1992	1.88	1.23	0.86	0.90	1.14	1.31	2.20
1991	1.73	1.03	0.84	0.88	1.05	1.29	2.02
1990	1.63	1.08	0.82	0.83	0.93	1.30	1.91

Table 12
Securities Gains (Losses) before Taxes as a Percentage of Total Assets*
(Insured commercial banks by consolidated assets)

Year	All Banks	\$0-\$25 million	\$25-\$50 million	\$50-\$100 million	\$100-\$500 million	\$500 million-\$1 billion	\$1 billion+
1994	(0.01)	(0.01)	(0.03)	(0.03)	(0.03)	(0.03)	(0.01)
1993	0.08	0.07	0.06	0.06	0.06	0.07	0.09
1992	0.12	0.11	0.08	0.09	0.09	0.08	0.13
1991	0.09	0.05	0.05	0.06	0.07	0.07	0.10
1990	0.01	0.00	0.00	0.00	0.00	0.01	0.02

*Asset amounts in billions of dollars. 0.00 indicates securities gains (losses) that are less than 0.01 percent of total assets.

Table 13
Percentage Return on Assets
(Insured commercial banks in the Southeast by consolidated assets)

Year	All SE Banks	\$0-\$25 million	\$25-\$50 million	\$50-\$100 million	\$100-\$500 million	\$500 million-\$1 billion	\$1 billion+
1994	1.29	1.06	1.16	1.21	1.37	1.30	1.28
1993	1.26	1.06	1.17	1.23	1.30	1.23	1.27
1992	1.05	0.73	0.98	1.06	1.13	0.97	1.05
1991	0.66	0.14	0.58	0.75	0.88	0.67	0.60
1990	0.52	0.03	0.60	0.64	0.82	0.65	0.41

Table 14
Percentage Return on Assets
(Insured commercial banks in the Southeast by state)

Year	All SE Banks	Alabama	Florida	Georgia	Louisiana	Mississippi	Tennessee
1994	1.29	1.25	1.29	1.29	1.45	1.22	1.23
1993	1.26	1.36	1.15	1.19	1.73	1.27	1.26
1992	1.05	1.24	0.86	1.26	1.13	1.11	1.03
1991	0.66	1.02	0.48	0.87	0.22	0.91	0.77
1990	0.52	1.02	0.28	0.89	0.18	0.72	0.42

Table 15
Percentage Return on Equity
(Insured commercial banks in the Southeast by consolidated assets)

Year	All SE Banks	\$0-\$25 million	\$25-\$50 million	\$50-\$100 million	\$100-\$500 million	\$500 million-\$1 billion	\$1 billion+
1994	15.41	9.50	11.16	12.40	15.19	16.00	16.23
1993	15.56	9.23	11.49	13.17	15.00	15.43	16.62
1992	13.72	6.52	10.00	11.79	13.76	13.10	14.73
1991	8.96	1.26	6.08	8.39	11.10	9.70	8.79
1990	7.14	0.13	6.33	7.22	10.34	7.65	6.28

Table 16
Percentage Return on Equity
(Insured commercial banks in the Southeast by state)

Year	All SE Banks	Alabama	Florida	Georgia	Louisiana	Mississippi	Tennessee
1994	15.41	15.22	16.64	14.04	16.33	13.99	14.96
1993	15.56	16.58	15.41	13.05	20.88	14.97	15.76
1992	13.72	15.83	12.12	14.08	15.73	13.77	13.83
1991	8.96	13.29	7.12	9.99	3.35	11.77	10.63
1990	7.14	12.99	4.16	10.87	2.73	9.27	5.75

Table 17
Adjusted Net Interest Margin

(Insured commercial banks in the Southeast by consolidated assets)

Year	All SE Banks	\$0-\$25 million	\$25-\$50 million	\$50-\$100 million	\$100-\$500 million	\$500 million-\$1 billion	\$1 billion+
1994	4.53	4.89	4.95	4.87	4.77	4.71	4.38
1993	4.53	4.80	4.81	4.75	4.64	4.53	4.45
1992	4.45	4.58	4.73	4.69	4.56	4.50	4.34
1991	3.78	4.04	4.18	4.18	4.20	3.89	3.53
1990	3.56	4.13	4.29	4.11	4.17	4.07	3.15

Table 18
Adjusted Net Interest Margin

(Insured commercial banks in the Southeast by state)

Year	All SE Banks	Alabama	Florida	Georgia	Louisiana	Mississippi	Tennessee
1994	4.53	4.37	4.58	4.33	5.24	4.72	4.36
1993	4.53	4.50	4.52	4.31	5.14	4.61	4.44
1992	4.45	4.59	4.42	4.47	4.51	4.55	4.26
1991	3.78	4.20	3.51	4.18	3.08	4.21	3.88
1990	3.56	4.11	3.18	4.30	3.08	3.84	3.33

Table 19
Tax-Equivalent Interest Revenue as a Percentage of Interest-Earning Assets
(Insured commercial banks in the Southeast by consolidated assets)

Year	All SE Banks	\$0-\$25 million	\$25-\$50 million	\$50-\$100 million	\$100-\$500 million	\$500 million-\$1 billion	\$1 billion+
1994	7.66	8.16	8.09	8.07	7.91	7.63	7.52
1993	7.61	8.20	8.16	8.05	7.80	7.40	7.46
1992	8.57	9.20	9.08	9.00	8.70	8.46	8.42
1991	9.91	10.16	10.33	10.25	10.10	9.86	9.75
1990	10.90	11.00	11.09	10.97	10.88	11.46	10.82

Table 20
Tax-Equivalent Interest Revenue as a Percentage of Interest-Earning Assets
(Insured commercial banks in the Southeast by state)

Year	All SE Banks	Alabama	Florida	Georgia	Louisiana	Mississippi	Tennessee
1994	7.66	7.87	7.48	7.88	7.72	7.84	7.52
1993	7.61	7.84	7.45	7.81	7.42	7.82	7.55
1992	8.57	8.75	8.44	8.91	8.28	8.70	8.42
1991	9.91	10.04	9.68	10.48	9.33	9.98	9.98
1990	10.90	10.84	10.66	11.47	10.56	10.67	11.24

Table 21
Interest Expense as a Percentage of Interest-Earning Assets
(Insured commercial banks in the Southeast by consolidated assets)

Year	All SE Banks	\$0-\$25 million	\$25-\$50 million	\$50-\$100 million	\$100-\$500 million	\$500 million-\$1 billion	\$1 billion+
1994	2.91	2.97	2.94	2.98	2.97	2.71	2.90
1993	2.76	3.05	3.01	3.01	2.87	2.48	2.70
1992	3.53	3.96	3.89	3.81	3.62	3.41	3.43
1991	5.23	5.45	5.52	5.42	5.27	5.22	5.16
1990	6.28	6.07	6.21	6.17	6.07	6.34	6.36

Table 22
Interest Expense as a Percentage of Interest-Earning Assets
(Insured commercial banks in the Southeast by state)

Year	All SE Banks	Alabama	Florida	Georgia	Louisiana	Mississippi	Tennessee
1994	2.91	3.28	2.68	3.09	2.65	2.96	3.03
1993	2.76	3.02	2.58	2.92	2.47	2.92	2.91
1992	3.53	3.66	3.42	3.69	3.26	3.66	3.59
1991	5.23	5.29	5.15	5.34	5.14	5.28	5.28
1990	6.28	6.25	6.27	6.16	6.24	6.21	6.57

Table 23
Loan-Loss Expense as a Percentage of Interest-Earning Assets
(Insured commercial banks in the Southeast by consolidated assets)

Year	All SE Banks	\$0-\$25 million	\$25-\$50 million	\$50-\$100 million	\$100-\$500 million	\$500 million-\$1 billion	\$1 billion+
1994	0.22	0.30	0.21	0.22	0.17	0.20	0.24
1993	0.32	0.34	0.34	0.28	0.30	0.41	0.31
1992	0.59	0.66	0.46	0.50	0.51	0.55	0.65
1991	0.90	0.67	0.63	0.65	0.63	0.76	1.07
1990	1.07	0.80	0.59	0.69	0.65	1.05	1.30

Table 24
Loan-Loss Expense as a Percentage of Interest-Earning Assets
(Insured commercial banks in the Southeast by state)

Year	All SE Banks	Alabama	Florida	Georgia	Louisiana	Mississippi	Tennessee
1994	0.22	0.22	0.22	0.46	(0.18)	0.16	0.13
1993	0.32	0.32	0.36	0.57	(0.19)	0.29	0.19
1992	0.59	0.50	0.59	0.75	0.51	0.48	0.57
1991	0.90	0.55	1.03	0.96	1.11	0.49	0.78
1990	1.06	0.47	1.22	1.00	1.23	0.62	1.34

Table 25
Nonperforming Loans as a Percentage of Total Loans
(Insured commercial banks in the Southeast by consolidated assets)

Year	All SE Banks	\$0-\$25 million	\$25-\$50 million	\$50-\$100 million	\$100-\$500 million	\$500 million-\$1 billion	\$1 billion+
1994	1.02	1.09	1.16	1.13	0.94	1.04	1.02
1993	1.60	1.45	1.37	1.36	1.31	1.44	1.75
1992	2.09	2.29	1.80	1.70	1.78	2.08	2.25
1991	2.57	2.32	2.21	2.05	2.12	2.50	2.81
1990	2.44	2.31	2.15	2.04	2.14	2.46	2.59

Table 26
Nonperforming Loans as a Percentage of Total Loans
(Insured commercial banks in the Southeast by state)

Year	All SE Banks	Alabama	Florida	Georgia	Louisiana	Mississippi	Tennessee
1994	1.02	0.65	1.34	0.91	1.20	0.82	0.63
1993	1.60	0.77	2.21	1.34	2.12	1.04	1.08
1992	2.09	1.00	2.59	1.72	3.57	1.36	1.66
1991	2.57	1.35	3.05	2.12	4.49	1.64	2.08
1990	2.44	2.31	2.15	2.04	2.14	2.46	2.59

Table 27
Loans by Category as a Percentage of Total Assets
(Insured commercial banks in the Southeast by consolidated assets)

Loan Category	All US Banks	All SE Banks	Alabama	Florida	Georgia	Louisiana	Mississippi	Tennessee
Commercial	15.53	13.02	14.96	9.57	18.76	10.71	10.50	13.87
Real Estate	25.97	34.43	36.97	41.45	28.45	23.17	29.89	32.58
Consumer	12.75	14.34	12.95	13.31	17.69	13.98	14.42	13.05
Agricultural	1.04	0.56	0.62	0.27	0.49	0.91	1.92	0.56
Credit Card*	4.88	4.01	1.80	3.55	8.87	2.07	0.74	1.85

*Credit card loans are a subset of consumer loans.

Table 28
Noninterest Income as a Percentage of Total Assets
(Insured commercial banks in the Southeast by consolidated assets)

Year	All SE Banks	\$0-\$25 million	\$25-\$50 million	\$50-\$100 million	\$100-\$500 million	\$500 million-\$1 billion	\$1 billion+
1994	1.44	1.85	1.29	1.44	1.25	1.21	1.65
1993	1.45	1.70	1.47	0.95	1.31	1.29	1.68
1992	1.42	1.54	0.99	1.05	1.20	1.24	1.31
1991	1.35	1.65	0.94	1.19	1.21	1.24	1.55
1990	1.26	1.23	0.91	1.06	1.08	1.12	1.39

Table 29
Noninterest Income as a Percentage of Total Assets
(Insured commercial banks in the Southeast by state)

Year	All SE Banks	Alabama	Florida	Georgia	Louisiana	Mississippi	Tennessee
1994	1.44	1.82	1.27	1.39	1.20	1.16	1.55
1993	1.45	1.18	0.79	1.78	1.41	1.50	1.59
1992	1.42	1.51	0.95	1.00	1.15	1.21	1.62
1991	1.35	1.21	1.26	1.76	1.27	1.00	1.33
1990	1.26	0.92	0.91	1.06	1.08	1.12	1.39

Table 30
Noninterest Expense as a Percentage of Total Assets
(Insured commercial banks in the Southeast by consolidated assets)

Year	All SE Banks	\$0-\$25 million	\$25-\$50 million	\$50-\$100 million	\$100-\$500 million	\$500 million-\$1 billion	\$1 billion+
1994	3.56	4.71	4.00	3.97	3.50	3.41	3.52
1993	3.68	4.71	4.21	3.53	3.65	3.57	3.68
1992	3.82	4.60	3.82	3.64	3.58	3.71	3.92
1991	3.72	4.92	3.75	3.72	3.58	3.60	3.74
1990	3.54	4.31	3.70	3.60	3.46	3.71	3.50

Table 31
Noninterest Expense as a Percentage of Total Assets
(Insured commercial banks in the Southeast by state)

Year	All SE Banks	Alabama	Florida	Georgia	Louisiana	Mississippi	Tennessee
1994	3.56	3.37	3.39	3.71	3.96	3.51	3.70
1993	3.68	3.43	3.66	3.91	3.78	3.39	3.65
1992	3.82	3.44	4.00	4.05	3.77	3.35	3.54
1991	3.72	4.92	3.75	3.72	3.58	3.60	3.74
1990	3.54	3.04	3.64	3.71	3.56	3.13	3.55

Table 32
Securities Gains (Losses) before Taxes as a Percentage of Total Assets*
(Insured commercial banks in the Southeast by consolidated assets)

Year	All SE Banks	\$0-\$25 million	\$25-\$50 million	\$50-\$100 million	\$100-\$500 million	\$500 million-\$1 billion	\$1 billion+
1994	(0.02)	0.03	(0.01)	(0.02)	(0.01)	(0.03)	(0.02)
1993	0.04	0.07	0.08	0.07	0.05	0.09	0.02
1992	0.09	0.09	0.10	0.08	0.08	0.03	0.09
1991	0.11	0.09	0.07	0.05	0.06	0.04	0.14
1990	0.02	0.00	0.00	(0.01)	(0.01)	0.01	0.04

* 0.00 indicates securities gains (losses) that are less than 0.01 percent of total assets.

Table 33
Securities Gains (Losses) before Taxes as a Percentage of Total Assets*
(Insured commercial banks in the Southeast by state)

Year	All SE Banks	Alabama	Florida	Georgia	Louisiana	Mississippi	Tennessee
1994	(0.02)	0.00	(0.02)	(0.01)	(0.12)	(0.02)	(0.02)
1993	0.04	0.05	0.04	0.03	0.04	0.02	0.03
1992	0.09	0.04	0.07	0.15	0.11	0.03	0.06
1991	0.11	0.06	0.15	0.11	0.12	0.50	0.37
1990	0.02	0.00	0.04	0.01	0.02	(0.01)	(0.00)

* 0.00 indicates securities gains (losses) that are less than 0.01 percent of total assets.

Notes

1. For the purposes of this article, the terms *South* and *South-east* refer to Alabama, Florida, Georgia, Louisiana, Mississippi, and Tennessee. The Sixth Federal Reserve District consists of those states, less portions of Louisiana, Mississippi, and Tennessee.
2. These largest banks account for approximately 75 percent of the total banking assets in the nation; hence, their performance strongly influences the measures for the "all banks" category. See Table 5 for the number of banks in each size class and Table 6 for total consolidated assets controlled by banks in each size class.
3. Some of the increase in assets and corresponding drop in ROA, particularly for the largest classes of banks, can be attributed to the adoption of Financial Accounting Standards Board Interpretation 39 (FASBI 39), which is discussed below.
4. For ease of exposition net loans and leases will be referred to as net loans throughout the remainder of this article.
5. This decrease is the effect of FASB 39 only. FASB 39 should directly affect only those banks dealing in derivatives; hence, the entire \$90 billion increase in assets that English and Reid (1994) calculate is due to FASB 39 is attributable to the large bank size class. SFAS 115 affects securities held by banks and has a much more pervasive influence. The affect of SFAS 115 is estimated to be \$11.56 billion, spread across all banks. Note that SFAS 115, which requires banks to mark more securities to market (rather than amortizing), will tend to shrink assets in a period of rising interest rates, such as 1994.
6. These more expensive sources include managed liabilities such as Federal Home Loan Bank borrowings, Eurodollar deposits, borrowings from overseas and nonbank affiliates, senior bank notes, and structured notes.
7. Noncurrent loans are accruing loans past due more than thirty days plus all nonaccruing loans.
8. The coverage ratio, or ratio of loan-loss reserves to noncurrent loans, has been reported for thirteen years.
9. For the purposes of this article, nonperforming loans are the sum of interest-accruing loans that are past due ninety days or more plus nonaccruing loans. (Increases in loans past due one to eighty-nine days would not be detected by this measure.)
10. Before FASBI 39, banks could net their off-balance-sheet derivatives across all counterparties. After FASBI 39, netting is limited to contracts with the same counterparty that meet certain other legal criteria. Since many of the derivative contracts could no longer be netted, some banks reported substantial increases in assets and liabilities for 1994, reducing their tier 1 leverage ratios. Regulatory risk-based capital ratios did not change as a result of FASBI 39 because the risk-based capital ratios used a gross, rather than a net, value of off-balance-sheet items to compute risk-weighted assets.
11. SFAS 115 forced banks to mark more securities to market than they had previously done. Marking these securities to market during a period of falling prices caused a decline in reported securities values. Additionally, SFAS 115's market-value accounting may have reduced banks' ability to manage earnings and increased volatility, since liabilities are not marked to market. These effects may have led to an actual reduction in securities held, as opposed to the direct-accounting reduction in value.
12. See "Spotlight on Profitability" (1995). A community bank is an FDIC-insured commercial bank that is independently owned or owned by a holding company with consolidated assets of less than \$1 billion as of December 31, 1994. For the purposes of this ranking, large community banks have assets between \$50 million and \$1 billion, while small community banks have assets of less than \$50 million. Only banks that have been profitable for the last three years were considered.
13. Louisiana banks' total noninterest expenses, wage and salary expenses, and premises and fixed-asset expenses were 3.96, 1.84, and 0.56 percent of total assets, respectively. By contrast, the national average for total noninterest expense was 3.78 percent of total assets, with employment expenses accounting for 1.59 percent and fixed-asset expenses for 0.50 percent of assets. In the Southeast, mean total noninterest expenses were 3.56 percent of total assets. Of these expenses, employment expenses were 1.47 percent and fixed-asset expenses were 0.47 percent of total assets.
14. See Tables 28-33 for additional information concerning noninterest expenses and revenues.
15. Related questions center on the extent to which banks will be held responsible for rebuilding the thrift insurance fund, whether the Saving Association Insurance Fund and Bank Insurance Fund will be merged, and whether banks will bear part of the obligation for the Financing Corporation bonds used to fund the thrift bailout.

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Review Essay

“Privatopia” and the Public Good

William Roberds

Alexis de Tocqueville was perhaps the first to note (in 1832) that Americans have an instinctive distrust of government and an equally instinctive passion for creating private organizations. Armed with these insights, Tocqueville would hardly be surprised by the modern-day ascension of the “common interest development” (CID) in the markets for residential real estate. In common interest developments such as condominiums, co-ops, and planned-unit developments of single-family homes, many of the traditional roles of local government are entirely ceded to a private entity such as a homeowner association. In a CID, membership in a governing association is a binding legal requirement for ownership of a residence within the development.

The common interest development is an increasingly popular form of residential community organization. The number of CIDs nationwide grew from 10,000 in 1970 to 130,000 in 1989, according to the Community Associations Institute. By the year 2000 the institute projects that there will be more than 200,000 CIDs and that 25 to 30 percent of Americans will be living in them (see Community Associations Institute 1993 and “Government by the Nice” 1992). Yet despite their popularity, common interest developments have been the subject of relatively little scholarly study. *Privatopia: Homeowner Associations and the Rise of Residential Private Governments* helps to fill this void by carefully documenting the history and legal structure of common interest developments.

A review of Privatopia: Homeowner Associations and the Rise of Residential Private Governments, by Evan McKenzie (New Haven, Conn.: Yale University Press, 1994), 248 pages, \$30.00. The reviewer is a research officer and senior economist in charge of basic research at the Atlanta Fed.

He would like to thank his colleagues, especially Zsolt Besci, for helpful discussions regarding this essay.

Evan McKenzie, who teaches political science at the University of Illinois at Chicago, begins by tracing the history of the modern common interest development from its origins in nineteenth-century utopian writings through its rediscovery in the postwar housing boom to its current state of widening popularity. The second half of the book provides a closer look at the organization and function of CIDs, with a particular emphasis on the legal basis for these developments under the laws of California.

The analysis in *Privatopia* leaves little doubt that the governing bodies (homeowner associations) of common interest developments are de facto private local governments. While McKenzie makes this argument in convincing detail, the essence of the argument can be reduced to three points.¹ First, CID homeowner associations typically have the power to tax, that is, to impose assessments against all members of the association. Second, these associations typically have the power to legislate, that is, to enact codes of behavior that must be followed by residents of the CID. Third, CIDs have the legal power to coerce residents to behave according to the rules set by the association.

Is this new form of government a good thing? One could imagine answers to this question falling along ideological lines, with advocates of smaller government answering in the affirmative. In reality, libertarian enthusiasm for this form of government may be tempered by the heavy-handed restrictions that are often placed on CID residents by their governing associations. Among the people, things, or behaviors that have been banned from various CIDs are children, spouses below a certain age, pets above a certain weight, signs of any type, pickup trucks, satellite dishes, the display of American flags on Flag Day, and kissing on the front steps. For many CID residents, less government turns out to mean more.

McKenzie notes that the governing associations of common interest developments are free to impose such onerous restrictions on their residents (subject to some constitutional limitations) because CIDs are in a legal sense private associations rather than governmental entities. Homeowners are required to sign agreements to abide by the rules of the association when they move to a CID. When legal action is needed to enforce these rules, cases are handled in civil rather than criminal court. In general, the courts have shown little inclination to interfere with what are viewed as purely private agreements.²

Many observers of the CID movement, McKenzie included, point to these restrictions as counter to traditional notions of democracy and individual freedom

(see, for example, "Government by the Nice" 1992 or Diana Jean Schemo 1994). *Privatopia* explains that many of these restrictions are not voted on by the populace of the development but are instead imposed ex ante by the developer. Once written into the "laws" of the governing association, such restrictions are often difficult to repeal because of supermajority requirements in the association's charter. In many of these developments, the notion of majority rule is further eroded by outright exclusion of renters from participation in the governing association.

Why, then, will one-quarter of the world's most democratic country soon find itself living under a form of local government that places such stringent limits on democracy? One plausible answer, which is given insufficient attention in *Privatopia*, is that the great majority of CID residents feel that the restrictions imposed by the governing associations are reasonable, if not desirable, constraints on social behavior. Certainly, common interest developments could not have become as popular as they have unless these restrictions enjoyed a certain degree of popularity.

Another plausible explanation for the rise of common interest developments is economics. McKenzie suggests that the principal driving force behind CIDs has been rising land costs and the consequent desire of developers to put more suburbia on less land. This is a valid argument but one that does not probe very deeply into the question of how the demand for suburbia arises in the first place.

One popular explanation for the postwar suburban explosion is improvements in transportation and communication technology. However, many economists believe that an equally important cause of suburbanization has been the market-driven phenomenon known as "Tiebout sorting," first described by Charles M. Tiebout (1956) as an explanation for the following situation. People cannot "purchase" the community in which they live as they might buy commodities like food or clothing because there are certain public goods and services, such as streets, police, and the like, that everyone in a given community will necessarily share in a roughly equal fashion. However, to a certain extent people are able to buy public goods and services in much the same way they buy other commodities: they may choose a community to live in on the basis of the level of public goods and services it provides and the corresponding levels of taxation levied to pay for these goods and services.

Since the Second World War, the evidence suggests that Americans have Tiebout-sorted themselves with a vengeance. The percentage of metropolitan residents

living in the suburbs rose from about 40 percent in 1950 to about 60 percent by 1988. Suburbs have tended to be smaller, relatively homogeneous communities that are politically dominated by homeowners (see J. Vernon Henderson 1995, 156). By placing restrictions on density, suburban residents can and often do appropriate a large share of goods and services provided by their communities for themselves.³ Suburban governments, like their homeowners, also typically have a preference for funding these goods and services by means other than property taxes, to the extent that doing so is possible (Henderson 1995, 156).

In light of these tendencies, the increasing popularity of common interest developments can be seen as resulting at least partly from the general postwar trend toward suburbanization and a greater degree of Tiebout

strategy that would not be open to a public entity. *Privatopia* notes that these policies of exclusion are unfair in the sense that residents outside of common interest developments do not have the option of excluding CID residents from their communities. Yet it is the same idea of exclusion that has underlain much of the trend toward suburbanization. The construction of walled and gated communities simply carries this idea one step further.

Second, the fiscal organization of common interest developments is also distinct from that of more traditional communities. The most important difference is that the common interest development budget is financed with lump-sum or poll taxes (commonly called association fees) rather than property taxes.⁴ That is, the assessments levied by the governing association typically do not increase with and are not directly correlated to the value of owners' property. Most economists regard lump-sum taxes as more efficient than property taxation because they are less discouraging to the accumulation of wealth in the form of real estate.⁵ However, poll taxes are generally politically unpopular and are rarely imposed by municipalities despite their evident popularity within CIDs.

Third, a key organizational feature of common interest developments that strongly encourages the use of lump-sum taxes is the denial of voting rights to renters. The fact that each voting member of the community must own property within the community means that there is little likelihood that voters will approve taxes that distort the process of their own accumulation of wealth.⁶

Privatopia does a good job of explaining why such organizational features are in conflict with the idea of democracy with universal suffrage. What is missing from the book, however, is an appreciation of the underlying economic forces that have led common interest developments to be organized the way they are. On the basis of economic analyses stemming from the Tiebout model, one would not expect these forces to be "developer greed" or any desire of affluent individuals to withdraw from society but instead people's natural desire to organize and finance their community in a way that does not place inefficient taxes on accumulation of wealth. Even though the results may sometimes violate our notions of democracy and fairness, the potential efficiency gains from CID-type arrangements and the natural tendency of people to avoid distortionary taxes on their own wealth should not be ignored.

The observation that common interest developments offer potential efficiency advantages over more

The challenge to common interest developments will be to devise forms of organization that incorporate efficiency advantages and at the same time ensure a greater degree of democracy and fair play.

sorting. The increased formation of suburbs has allowed suburban residents to effectively privatize many local public goods and services. Common interest developments in effect allow their residents to create suburbs within suburbs, carrying the process of privatization one step further. CIDs are able to accomplish this finer degree of sorting because their organization differs from that of traditional suburbs in a number of important ways.

First, the de jure private nature of common interest developments makes it easier for them to enforce the restrictions that lead to Tiebout sorting. It costs relatively little to set up a common interest development as compared with incorporating a traditional suburb, and, as McKenzie points out, the private nature of CIDs' governance makes their land-use restrictions difficult to defeat in court. The perennial problem of nonresidents "free riding" on goods and services provided by a community is often solved by physical exclusion of nonresidents from the common interest development, a

traditional forms of local government should not be interpreted as an argument that CIDs in their current state represent the ideal form of social organization or that governmental redistribution of wealth is always a bad thing. Common interest developments represent a new way of avoiding wealth redistribution through local property taxes, though it can be argued that postwar suburbanization has eroded much of the ability of local governments to redistribute wealth. Nevertheless, all governments redistribute wealth in some fashion, and the relevant policy question is whether the erosion of governments' ability to redistribute wealth through property taxes will result in a more or less efficient allocation of wealth.

It is also worth noting that the potential efficiency gains offered by common interest developments do not imply that efficient forms of local governments will necessarily impose onerous restrictions. Indeed, the growing criticism of traditionally heavy-handed CID "governments" suggests that reform or at least innovation is needed in this area. Even as conservative a voice as the *Wall Street Journal* noted in a recent article that many CID residents feel that the restrictions imposed

by their governing associations are unnecessarily intrusive (see Fara Warner 1995). Just as there are many homeowners who place a high value on the security and stability of their community, there are also many who value the idea that the organization of their community should be consistent with ideas of democracy, individual liberty, and fairness. The apparent challenge to both the advocates and the critics of common interest developments will be to devise forms of community organization that incorporate the efficiency advantages of the common interest development and at the same time ensure a greater degree of democracy and fair play. If future housing markets are to be dominated by common interest developments, then it seems that the design and organization of some segments of the CID industry will have to accommodate more diverse forms of community "government."

McKenzie does not try to make any predictions concerning when, how, or even if such changes are likely to occur. However, *Privatopia* offers a well-researched and much-needed look at some basic issues that underlie an increasingly prevalent form of community organization.

Notes

1. The argument here follows that made by Garreau (1991, chap. 6).
2. However, some states now require that disputes between homeowner associations and residents first go through a non-judicial dispute resolution process before they can be brought to court.
3. There is some debate over the effectiveness of traditional zoning restrictions in achieving this end. See Mieszkowski and Zodrow (1989) for a review of this literature.
4. Of course, residents within common interest developments must continue to pay property and other taxes imposed by the state and municipality in which the CID is located, in addition to the association fees. McKenzie points out (192-97) that many CID residents are extremely dissatisfied with this situation, which they regard as one of "double taxation." However, the labeling of association fees as taxes tends to undermine the notion that the associations are private rather than governmental organizations.
5. The efficiency of lump-sum taxes is a standard result of welfare economics (see, for example, Layard and Walters 1978). The basic idea is that if taxes do not depend on people's actions, then people will not modify their economic decisions in response to these taxes. Mieszkowski and Zodrow (1989) note that there are some important qualifications to the traditional conclusion that head taxes represent the most efficient form of taxation. In models in which negative congestion effects result from the free migration of residents among different regions, poll taxes are inefficient and the most efficient form of taxation is a tax on land (but not on improvements to land). Because this form of taxation has not received widespread political support within the United States, it is not considered further in the discussion above.
6. This phenomenon is formally demonstrated in Henderson (1995).

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