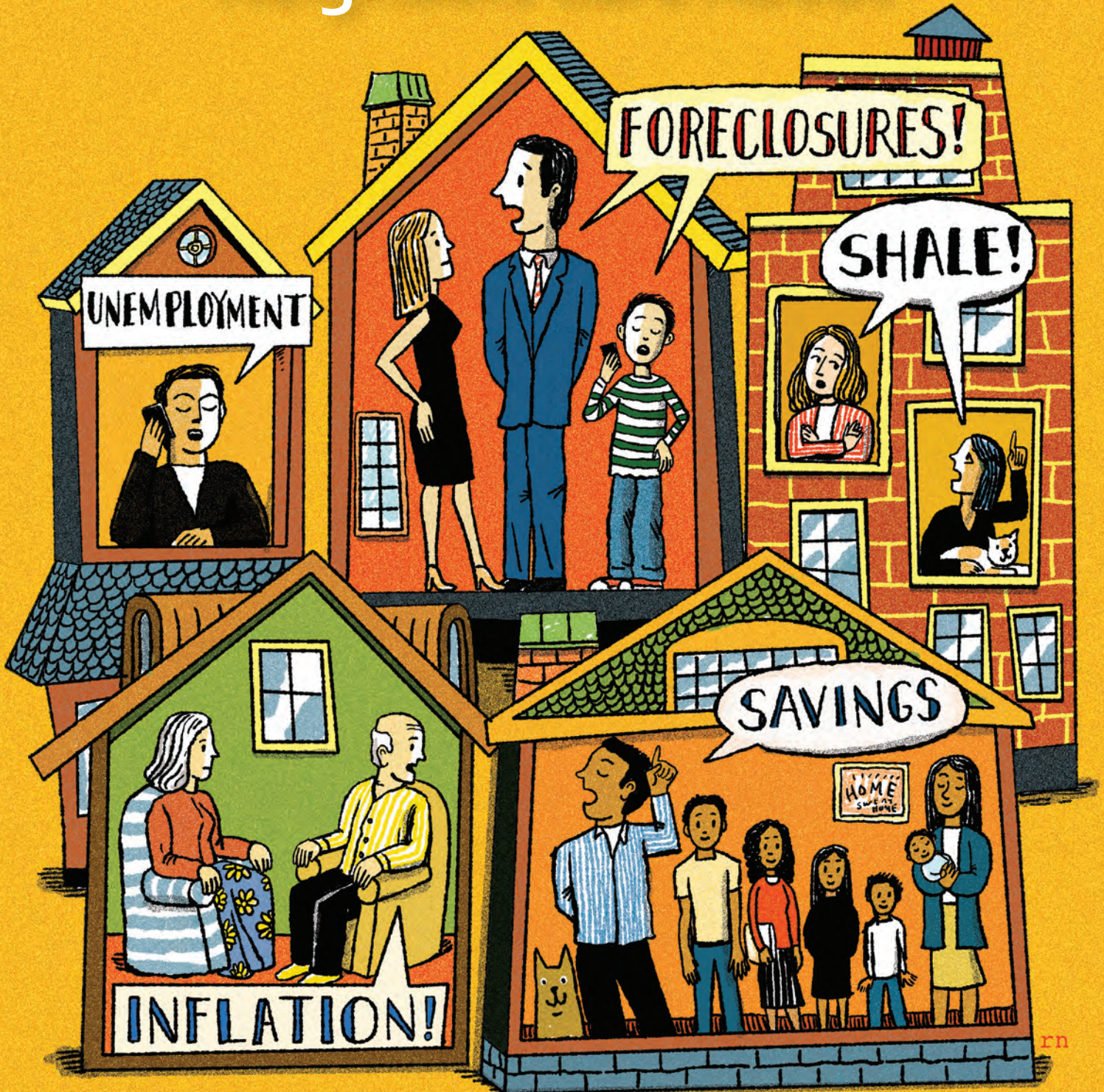


Forefront

New Ideas on Economic Policy from the FEDERAL RESERVE BANK
of CLEVELAND

The Things Our Neighbors Care About





Amy Koehnen
Editor

Five years after the worst recession in decades officially ended, Americans remain anxious. They worry about their homes, their jobs, their finances, and their futures. Consider this: The August numbers from the Survey of Consumers by Thomson Reuters/University of Michigan reveal only 21 percent of all consumers expect the economy to improve in the year ahead, while 26 percent expect overall economic conditions to worsen.

While much of our research at the Cleveland Fed is focused on making informed contributions at the Federal Open Market Committee to help formulate national monetary policy, our researchers also study matters that are commonplace in everyday life: the well-being of our neighborhoods, the level of our household debt, the security of our retirement. We're driven to study these and other day-to-day issues because we know that the more you know about your economy, the better you can make choices that enhance your futures, and those of your communities.

In that spirit, I offer you this issue of *Forefront*. In it, we cover many of the things our neighbors (and yours) care about: foreclosures, the shale gas boom, inflation and wages, household finances, and more. I invite you to read our coverage, then share your own experiences.

Tweet us at @ClevelandFed,
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CONTENTS

-
- 1 Path to the Presidency

 - 2 Upfront
Costly coins; the latest stress test results

 - 4 The Prices We Pay
Four reasons why many economists believe that inflation is poised to rise.

 - 10 Policy Watch: Zombie Properties
Can a fast-track process help to mitigate the impact of vacant foreclosures?

 - 12 Hot Topic: Running Out of Options?
One outlook for the long-term unemployed

 - 14 Getting Our House in Order
US households are saving less and borrowing more than they did right after the Great Recession.

 - 18 Municipal Bankruptcy's Tug-of-War
When a municipality files Chapter 9, questions abound.

 - 22 Deep Wells, Deep Pockets, and Deep Impact
The shale gas industry is here, and with it come costs and benefits.

 - 26 Measuring America: Interview with Erica Groshen
The Bureau of Labor Statistics commissioner gives *Forefront* the stats on inflation and unemployment, and the many hands it takes to produce them.

 - 32 Book Review
The Divide: American Injustice in the Age of the Wealth Gap
-

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Path to the Presidency

Meet Loretta Mester, the Cleveland Fed's new President and CEO

Graduates with a PhD in economics from Princeton University, the same place she earned her master's. Her thesis title? "Three Essays on Industrial Organization: An Empirical and Theoretical Analysis of the Structure and Behavior of Savings and Loans."

Begins teaching at the University of Pennsylvania's Wharton School, first as a lecturer and presently as an adjunct professor of finance

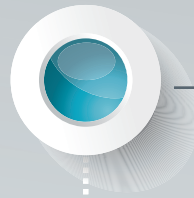
Becomes senior vice president and director of research for the Philadelphia Fed

Serves for four months as a visiting Reserve Bank officer in the Division of Monetary Affairs at the Board of Governors of the Federal Reserve System

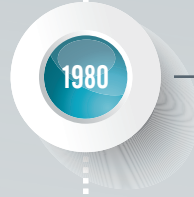
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Assumes a three-year term as co-editor of the *International Journal of Central Banking*

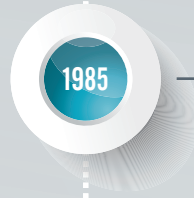
June 1 Becomes the 11th president and CEO of the Federal Reserve Bank of Cleveland, and a member of the Federal Open Market Committee



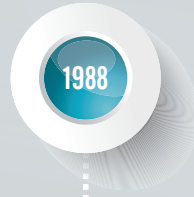
Loretta Mester attends Bel Air High School in Bel Air, Maryland. In 2010, Bel Air was home to a little more than 10,000 people.



Graduates summa cum laude with a BA in math and economics from Barnard College of Columbia University



Starts her career with the Federal Reserve System as an economist for the Philadelphia Fed



Begins teaching at the University of Pennsylvania's Wharton School, first as a lecturer and presently as an adjunct professor of finance



Becomes senior vice president and director of research for the Philadelphia Fed



Serves for four months as a visiting Reserve Bank officer in the Division of Monetary Affairs at the Board of Governors of the Federal Reserve System



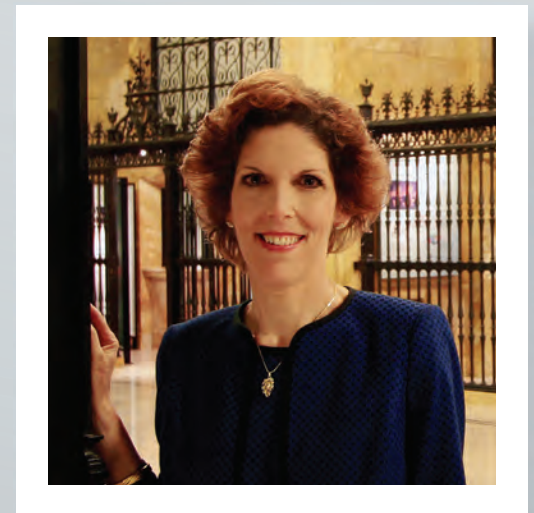
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"Explaining the factors that influence the changes in the outlook and FOMC policy decisions, as well as how the FOMC plans to conduct policy, can help the public make informed expectations as the economy evolves and monetary policy travels back to normal."

—September 4, 2014

Costly Coins

Eight consecutive years.

That's how long the unit cost of producing and distributing pennies and nickels has been more than they're worth in commerce, according to the US Mint's 2013 annual report. Last fiscal year alone, the Mint says, those unit costs generated a \$104.5 million loss.

Beginning this March and concluding in June, the Mint solicited input from coin industry stakeholders, of which the Federal Reserve is one, about the impact of changing the characteristics of our coins, including weight, electromagnetic signature, and color, if coin material (i.e., the metals in coins) were changed.

The US Mint is required to report its research to Congress in December.

Also this June, a hearing before the US House of Representatives' Financial Services Subcommittee on Monetary Policy and Trade examined, in part, how the rising costs of commodity metals have made it significantly more expensive for the Mint to produce its coins, especially pennies and nickels.

For several years, the cost of producing and distributing the penny and the nickel has been higher than their face values. Recently, the US Mint sought comment on change to ... change.

"That cost is borne by the taxpayer," explains Dan Littman, senior payments research consultant with the Federal Reserve Bank of Cleveland.

"This is a common problem across many countries: Their lowest denomination coins are not cost effective. They've lost their commercial value because of gradual inflation and because of the cost of metals," Littman says.

Some say we've reached a point where pennies have lost their circulating usefulness to Americans. When was the last time, they ask, that you paid for a loaf of bread with a fistful of pennies?

The Royal Canadian Mint stopped minting its penny in February 2012 and stopped distributing it a year later.

Though the Federal Reserve does not issue coins into circulation, nor determine annual coin production (that's the Mint's purview), the Reserve Banks do influence the process by providing the Mint with monthly coin orders and a 12-month, rolling coin-order forecast. The Reserve Banks purchase, at face

value, the circulating coins issued by the Mint, and distribute new and circulated coin to depository institutions to meet public demand.

In a statement submitted to the Subcommittee on Monetary Policy and Trade on June 11, 2014, Louise Roseman, director of the Federal Reserve Board's Division of Reserve Bank Operations and Payment Systems, explained that changing the metal content of pennies and nickels, which could change the weight and electronic signature of the coins, could affect businesses that use coin-accepting machines or sorting equipment. Among those that could be affected are the vending industry, some commercial banks, and armored carriers.

As for the Fed, Roseman explained that changing the metal content of pennies and nickels would not have a material adverse effect on the Reserve Banks' operations, but could affect Reserve Bank coin terminal operations because operators generally weigh incoming deposits.

—Michelle Park Lazette

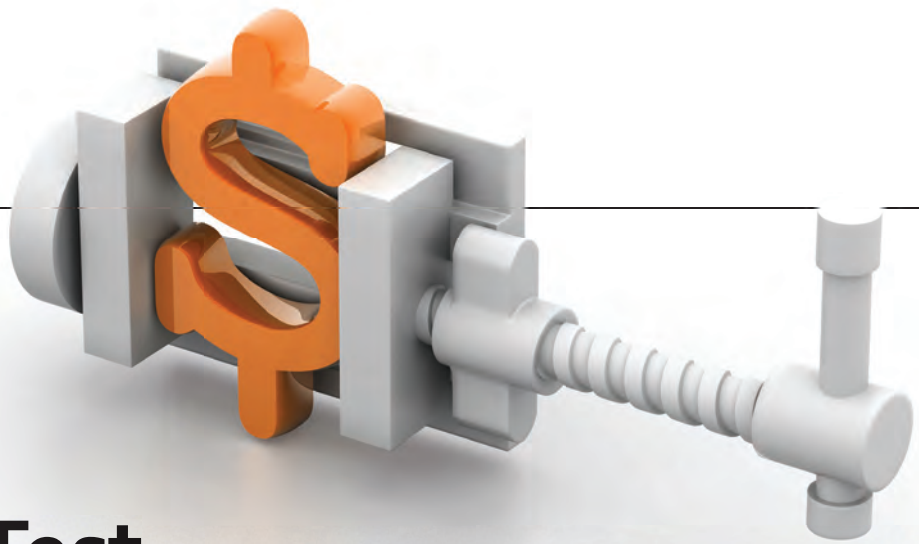
Did you know?

Though the penny and nickel cost more to make than their face value, all coins' total unit costs dropped in fiscal year 2013 compared to the prior fiscal year.

	PENNY	NICKEL	DIME	QUARTER
2013	1.83¢	9.41¢	4.56¢	10.50¢
2012	2.00¢	10.09¢	4.99¢	11.30¢
2011	2.41¢	11.18¢	5.65¢	11.14¢

Source: 2013 Annual Report, US Mint.





Put to the Test

In its latest round of stress tests, the Federal Reserve assessed the capital plans of the 30 largest banking firms in the country. Here's what that means.

Thirty of the nation's largest bank holding companies participated in an intensive capital stress test earlier this year.

Based on the review, the Federal Reserve objected to the capital plans submitted by five participants and did not object to the plans for the remaining 25 firms.* An objection signals that weaknesses are noted in the firm's capital-planning processes, particularly its ability to determine the capital needed to withstand severe economic conditions. Bank holding companies receiving an objection may pay cash dividends or complete stock redemptions only with prior Federal Reserve approval.

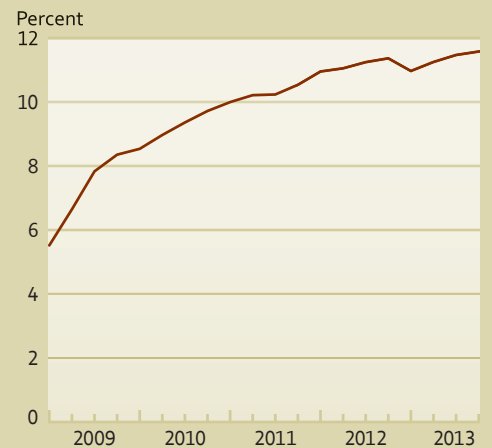
Under the annual stress test, known as the Comprehensive Capital Analysis and Review, participant firms are required to report their capital stress test results under projected baseline (business as usual) and hypothetical, stressed economic scenarios. The Federal Reserve uses this information to evaluate the capital adequacy of

each firm and also the strength of their capital-planning processes. The annual review is an integral part of the Federal Reserve's efforts to ensure the financial resiliency of the nation's largest banking organizations.

"The Federal Reserve's heightened focus on capital planning at the nation's largest financial institutions helps to ensure these important firms have a thorough understanding of their key risks and how capital levels may be impacted under severe economic conditions," says Jeffery Hirsch, a banking supervisor at the Federal Reserve Bank of Cleveland who worked as a co-deputy for one of the national assessment teams that support the annual review.

"The goal of forward-looking capital planning is to ensure each firm's board of directors is well informed when making important capital decisions, such as setting capital goals or authorizing stock dividends," Hirsch explains.

Since stress-testing began, capital levels have climbed



Source: Board of Governors of the Federal Reserve System.

As an end goal, Hirsch says, the Fed wants to make certain these firms are well positioned to absorb losses in good times and bad and are able to maintain ready access to funding (in the form of consumer deposits and wholesale funds); meet the obligations of their creditors and counterparties; and continue to lend. These are important roles played by banks within the local and national markets they serve.

"Ensuring effective capital planning, including rigorous stress testing, is a key component in the Federal Reserve's financial stability efforts," Hirsch says. ■

* See www.federalreserve.gov for the latest updates.

—Forefront Staff

The Prices We Pay

Many economists believe that inflation is poised to rise. Here are four reasons why.



Michelle Park Lazette
Staff Writer

Today's millennials may have little to no firsthand recollection of a time when inflation reached double-digit rates, but those who lived it might remember the year Gerald Ford declared inflation "public enemy number one" and the mass-produced "Whip Inflation Now" buttons that followed.

rn

“Not only was inflation very much on the minds of ordinary consumers, but ordinary consumers started judging the economy through the lens of inflation,” explains Richard Curtin, director since 1976 of the Thomson Reuters/University of Michigan Surveys of Consumers. “If you talk to the consumer about the current economy, they almost invariably bring up employment. In the late ’70s, they would invariably bring up inflation and how it affected them.”

Today, the American public is much more preoccupied with something else.

“The impact of the recession on a variety of things, including employment, has kept the consumer focus on jobs and wage growth more than inflation,” Curtin explains.

That may be, but the Federal Reserve Bank of Cleveland remains concentrated on inflation, and for good reason. It still matters in today’s environment, and arguably always will.

“Not only does price stability make the economy work more efficiently because households and businesses don’t have to worry about the value of their money ... it also promotes maximum employment, the other part of the (Fed’s) dual mandate,” says new Cleveland Fed president and CEO Loretta Mester. “The only entity that can deliver on price stability is the central bank.”

Just this spring, the Cleveland Fed published an essay in its annual report about why inflation is low and why it matters. It also launched its Inflation Central website, which offers a daily “nowcast,” or estimate of the current rate, of inflation. This May, it also convened economists and business people for its “Inflation, Monetary Policy, and the Public” conference. A key takeaway? Keeping an eye on inflation—both where it is today and where it is headed—is critical to guiding sound policy decisions and making sure Americans have confidence in the stability of prices.

The reality is that even though inflation has moved up from its very low 2013 levels, it remains low. In a press conference following the Federal Open Market Committee meeting in June, Federal Reserve Chair Janet Yellen noted that inflation continues to run below the FOMC’s 2 percent objective and that the FOMC remained mindful that inflation running persistently lower could pose risks to economic performance.

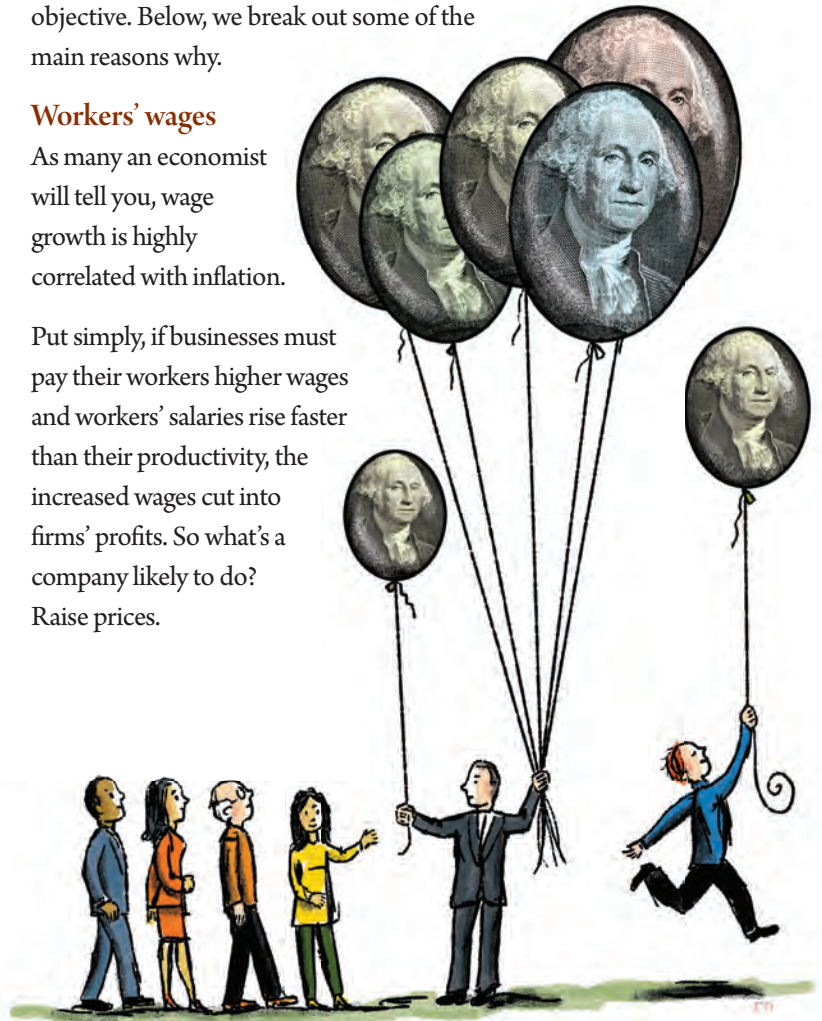
Recent evidence, Yellen added, suggested that inflation is moving up toward that 2 percent objective, in line with where the Committee expected inflation to be.

Like the FOMC, many economists expect inflation to gradually rise in the near term to around that 2 percent objective. Below, we break out some of the main reasons why.

Workers’ wages

As many an economist will tell you, wage growth is highly correlated with inflation.

Put simply, if businesses must pay their workers higher wages and workers’ salaries rise faster than their productivity, the increased wages cut into firms’ profits. So what’s a company likely to do? Raise prices.



Mark Zandi, chief economist for Moody’s Analytics, is not alone in predicting that wage growth will increase, and he expects it to be a slow build.

“Labor costs are the most important costs for most businesses, particularly obviously on the service side of the economy,” he says. “As the job market improves, as the unemployment rate declines ... we’re going to get to a point, probably two and a half, three years down the road, where the labor market will be tight enough so that workers will be able to demand and get bigger pay increases.”

If inflation rises from around 2 percent to 3 percent, it may not make a significant difference if it persists for a year or two years. But if it's a one-point difference for three, five, even 10 years, people start to feel it.

Wage growth data has been somewhat of a mixed bag, according to Edward S. Knotek II, vice president of economic forecasting at the Federal Reserve Bank of Cleveland and co-author of its 2013 Annual Report essay on why inflation has been very low.

“You’re seeing pretty modest wage growth,” he notes. “Some of the data have a flat trajectory in wage compensation pressures, but there are a couple that are starting to show some increases. But again, they are still at low levels.”

Cleveland Fed economist Saeed Zaman notes that as the economy improves, unemployment will decline further and the potential for wage increases will likely grow.

“If, in my neighborhood, there were two households looking for jobs before, they have jobs now,” he says of the potential future. “More jobs just means they are going to go buy more stuff, which they probably had cut off because they were not getting income. Now they have income to spend. Demand for products is going to push prices up.”

If a manufacturer, for example, sees the demand for his product triple, he’s able and likely to raise his prices, Zaman explains.

The cost of shelter

Zandi of Moody’s Analytics expects shelter costs, or rents, to rise much more quickly going forward. Such an acceleration in shelter costs will help push up inflation, too.

“We’re going from an environment in the bubble where we had a surfeit of housing, just overbuilding everywhere, to an environment where there’s just a real shortage of housing,” says Zandi. “We have a lot of 20-somethings that are graduating, going back into the workforce, and they’re going to rent and they’re going to need a place to live.”

“Most people spend 30, 35, 40 percent of their income either on renting a place where they live or through the cost of owning a home,” he adds. “So, if that cost is rising quickly or more quickly, that’s a higher rate of inflation cutting into their living standard.”



Overall, Zandi projects the inflation rate will accelerate slowly, peaking close to 3 percent in 2017.

If inflation rises from around 2 percent to 3 percent, it may not make a significant difference if it persists for a year or two, he says. But if it's a one-point difference for three, five, even 10 years, people start to feel it.

That's because if wages don't rise in lockstep with inflation, people's purchasing power is diminished, Zandi says.

"I think if inflation remains in the ballpark of my forecast, it's not really going to matter a whole lot to people," he notes. "They're going to be much more focused on, 'Do I have a job?' and 'If I have a job, am I getting a pay increase?'" If, though, inflation were to accelerate meaningfully more — 5 or 6 percent — then that's a problem for people. It really does cut into their purchasing power and into their standard of living."

Bet your bottom dollar: Why inflation, and its trajectory, matter

"Inflation is kind of a signal of how the economy is doing. When you see inflation rates of around 1 percent, that might suggest that the economy is not firing on all cylinders. When you see inflation get too high, that might mean the economy is overheating. The goal is to have inflation that's not too high and not too low."

— **Edward S. Knotek II**, *vice president*
Federal Reserve Bank of Cleveland

"Generally people have kind of forgotten about inflation as an issue. You go back into the '70s and the early '80s when inflation was raging, that was on everyone's top of mind. People still worry about it, particularly in the context of the prices for certain things, like the price of gasoline, or rent, or food. Generally, they're not really focused on it because inflation has been low and relatively stable. I think it's important, though, for people to remain focused on it because there's always the chance that inflation could begin to accelerate more than anticipated. [It's] very likely inflation over the next five years is going to be a lot higher than inflation over the past five years."

— **Mark Zandi**, *chief economist*
Moody's Analytics

"If I were to ask you, 'When you retire 20 years from now, 30 years from now, you're going to be living in a 2,000-square-foot home. Is that a good-sized home?' you could answer immediately, 'Yeah,' because you understand what that is. But if I were to say, '20 years from now, you're going to be getting a retirement income of \$30,000 a year. Is that a good retirement income?' now you've got to think harder. You don't know exactly what this thing we call a dollar is going to be able to purchase in that period of time."

— **Michael Bryan**, *vice president and senior economist*
Federal Reserve Bank of Atlanta

"Most households are forward-looking. Their actions today are based on what they think about the future. If they think there's going to be more inflation one year from now, that means things will be more expensive, so they will accordingly buy things now. On the other hand, if they think inflation is going to be low next year, they would postpone some of their consumption. Inflation affects their consumption behavior, which affects the overall economy. That's why central banks would like to maintain a stable inflation rate."

— **Saeed Zaman**, *economist*
Federal Reserve Bank of Cleveland

"If your income is going up faster than the inflation rate ... you don't really have to cut back on things that are more expensive, from eating more expensive cuts of meat to less expensive, buying store-brand rather than name-brand. But when your income is stagnant and inflation is still rising, you have to make these judgments almost every month. And depending on your situation, you may be subject to a higher inflation rate than other households. You may suffer some medical setbacks, and you have to buy drugs that have a higher inflation rate than other goods; or you're a young person and trying to buy a home and find that even these small increases in home values can shut you off from the home market."

— **Richard Curtin**, *director*
Thomson Reuters/University of Michigan Surveys of Consumers

Commodities are tightly linked to geopolitical factors, are tightly linked to weather factors, are tightly linked to things that are really out of our control.

Commodity prices

Commodities — examples are oil, copper, lumber, and food — can and do swing up and down. They play a role in inflation broadly and also in people’s perceptions.

“Commodities are tightly linked to geopolitical factors, are tightly linked to weather factors, are tightly linked to things that are really out of our control,” explains the Cleveland Fed’s Knotek.

Said another way: It’s hard to predict in the short term exactly what they will do.

Recently, there have been increases in the prices of food, gas, and oil, Knotek notes. The general sense is that some of that is short-term volatility, he adds, citing drought and swine flu as examples of special factors that have driven up food prices. Consider, too, the unrest in Iraq, which unexpectedly helped push up the price of oil in the early part of this summer.

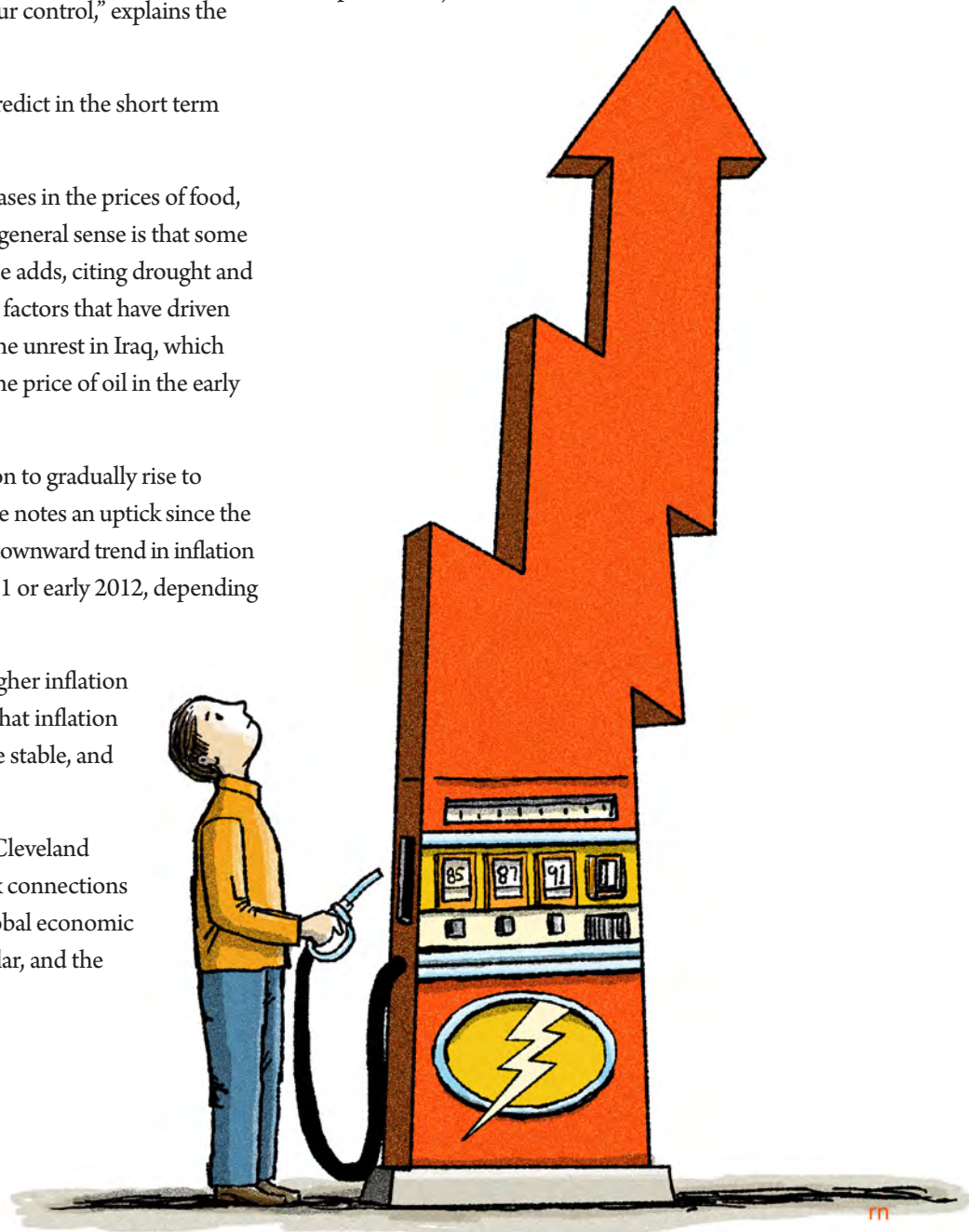
Overall, Knotek expects inflation to gradually rise to 2 percent by the end of 2016. He notes an uptick since the beginning of 2014, following a downward trend in inflation that had persisted since late 2011 or early 2012, depending on the measure one uses.

His anticipation of a slightly higher inflation rate is also rooted in his belief that inflation expectations will continue to be stable, and that the economy will improve.

Speaking of commodities, the Cleveland Fed’s Zaman notes the complex connections between commodity prices, global economic conditions, the value of the dollar, and the inflation rate.

For example, improvements in economic prospects abroad tend to bid up the prices of commodities such as oil and iron by increasing the demand for them, he says. Meanwhile, movements in the value of the dollar are another wild card in forecasting inflation, because they can affect the prices of commodities and many of the imported goods Americans purchase.

An unexpected surge in commodity prices could boost inflation here in the US, which is a perennial possibility. But Zaman expects that moderate increases in commodity prices should help bring inflation back toward the FOMC’s 2 percent objective.



What we, the public, expect

According to the Thomson Reuters/University of Michigan Surveys of Consumers in August, the year-ahead inflation expectation was 3.2 percent.

“Change in prices is something that people confront every day, and it’s really a good part of their economic lives, and they are quite aware of inflationary trends,” Curtin says. “I think that’s somewhat surprising to observers of the national economy: Each consumer has their own inflation expectation, and when you combine it, aggregate it across all households, that’s where you get the accurate predictions.”

Economists pay a lot of attention to inflation expectations. Many surveys suggest that people believe the recent, very low inflation readings to be temporary. The expectation that inflation will rise will help raise actual inflation.

“Today’s inflation rate depends a lot on what you expect inflation to be in the future,” the Cleveland Fed’s Knotek says. “We spend a lot of time thinking and looking at what people expect inflation to be.

“If all workers believed that prices would start to rise, they might say, ‘I need to be paid more to compensate for that,’ which then would lead to higher wages, and firms might increase prices,” Knotek explains.

Each consumer has their own inflation expectation, and when you combine it, aggregate it across all households, that’s where you get the accurate predictions.

The same is true of people who own businesses or firms.

“If I expect the prices of coal and iron ore to rise because my inflation expectations have risen, I’m going to try to pass those [increases] along,” Knotek says.

People’s short-term inflation expectations are very sensitive to movements in oil prices, he adds.

“It’s well known that movements in oil and gas prices impact how we think about inflation,” Knotek says.

Of course, forecasting is uncertain. It is trying to predict the future, after all. Knotek puts it this way: “At the end of the day, there are inherent limits to the knowability of the future, especially when little events can happen that have big consequences in some markets and big impacts on prices.” ■

On the reel



Forefront hits the streets of Cleveland to ask people which direction they expect inflation to go. Plus economists and business people explain why this unusual environment is exactly the time to pay keen attention to inflation. Watch now: www.clevelandfed.org/forefront

Read more



Find daily inflation nowcasts and more on the Cleveland Fed’s Inflation Central website: www.clevelandfed.org/inflation-central

Tweet us



Is inflation on your radar now? Why or why not? Tweet us [@ClevelandFed](https://twitter.com/ClevelandFed). Use the hashtag: [#inflationcentral](https://twitter.com/inflationcentral)

Zombie Properties



Michelle Park Lazette
Staff Writer

Many familiar with the foreclosure process have argued for some time that there's a need for speed—particularly when what's foreclosed on is vacant property that may sap neighbors' property values and be exploited by criminals.

This April, one fast-track option took another step forward when the Ohio House of Representatives unanimously passed a bill.

It remains to be seen, however, whether Amended Substitute House Bill 223, which authorizes municipal corporations to file for summary foreclosure on vacant and abandoned residential properties, will make it through the Ohio Senate before December 31, the end of the 130th General Assembly. If it does not, legislators would need to reintroduce the bill in 2015 for consideration in both the House and Senate.

Neither the bill nor the Cleveland Fed's attention to vacant foreclosures—so called zombie properties—is new.

Vacant, foreclosed properties cost creditors tens of millions of dollars, draw crime to neighborhoods, and drain municipalities. Can a fast-track process earn approval—and can it help?

The initial bill was introduced in June 2013, a month after the Cleveland Fed released a white paper titled "Policy Considerations for Improving Ohio's Housing Markets," which suggested implementing a fast-track foreclosure for vacant and abandoned properties.

As *Forefront* went to press, the bill was pending in the Senate Finance Committee.

In March, Cleveland Fed researchers found that in 2013, the fast-tracking of vacant foreclosures could have saved creditors \$24 million to \$129 million in Ohio and \$24.3 million to \$54 million in Pennsylvania. In both states, courts handle foreclosures.

That same month, the issue took center stage during a one-day seminar called "Getting Back in Gear: Better Ways to Move Stalled and Vacant Foreclosures Forward" at the Federal Reserve Bank of Cleveland.

Roughly 125 people, including community leaders, lenders and servicers, and foreclosure attorneys attended, and the Cleveland Fed streamed the conference to an additional 120 people in 11 states and Canada. Speaking at the start of the seminar, Paul Kaboth noted an anomaly in foreclosure numbers.

"The number of homes and loans entering foreclosures is down," said Kaboth, vice president of community development at the Cleveland Fed. "They're still elevated, but the numbers have declined. Yet, the time that loans and homes stay in foreclosure has increased."



"We just don't understand why this is the case," he continued. "There could be a variety of reasons."

It could be that loan modifications have not been effective, or have sometimes been introduced into futile situations, he told the crowd. In some such situations, borrowers couldn't afford the modified mortgage payments, period; in others, they could initially, but later couldn't because of subsequent shocks, such as job loss.

Also, he asked, where are the bottlenecks in the judicial foreclosure process?

"We ask ourselves these questions, but it's really hard to get around the answer," Kaboth added. "And then finally—and really the impetus for today's session—is: Are there more productive ways that we can address this foreclosure issue and this delay? It's a problem for everyone."

Just ask Benjamin Brown with the building department of Warrensville Heights, Ohio, who shared his perspective at the "Getting Back in Gear" event.

"One of the biggest problems we have, and one of the most frustrating problems we have, is the properties that have been charged off on and they're vacant," he explained. "So now we have a property that's sitting dilapidated; we can't establish contact with the owner; and we just have a property that's sitting in limbo."

In one recent case, a vacant condo began developing mold that affected adjoining units, Brown said, so the city had to step in, tear out drywall, and replace the roof.

When it comes to properties in foreclosure, it takes an average of one to two years for mortgage loans to go from delinquency through the foreclosure process in Ohio, according to the Cleveland Fed's May 2013 white paper.

And this appears a widely accepted truth among creditors, municipal leaders, and researchers: The longer properties sit vacant, the more collateral damage they inflict.

There's the carrying cost to creditors, which includes ongoing maintenance, code-violation citations, repairs, and taxes for properties that sit in creditors' real-estate-owned, or REO, portfolios. (That's industry-speak for foreclosed property owned by institutions.)

Nationally, creditors' carrying costs are estimated at between \$25 and \$100 a day, though conversations with loan servicers working in Ohio and Pennsylvania suggest costs closer to \$50 to \$100 a day, according to the Cleveland Fed's Tom Fitzpatrick, assistant vice president for credit risk management, and Kyle Fee, economic analyst.

But the costs to creditors don't tell the whole story; for many, the greatest benefit of fast-tracking vacant foreclosures is what it spares neighborhoods and municipalities.

"We measured the cost to creditors because that's what we can do," Fitzpatrick explains. "The cost to communities and municipalities is likely much larger."

Those costs, which are harder to measure with any specificity, include the drag of foreclosed, empty houses on neighboring property values and the crime introduced by those who capitalize on abandoned properties to steal or to conduct illicit business.

"The societal cost of these zombie properties is enormous," says Rep. Mike Curtin (D-Columbus), who introduced House Bill 223 with Rep. Cheryl Grossman (R-Grove City).

Even if fast-tracking foreclosures gets the Senate's blessing and Ohio joins the other states that allow it, Fitzpatrick stresses that the features of whatever process is created are what counts. In some states where fast-tracking already exists, practitioners aren't actually using it because they don't find it to be pragmatic.

"It appears if this is done effectively and in a way that gets everybody's voice heard at the table, there are some real benefits to be gained," Fitzpatrick says.

Through efforts like the "Getting Back in Gear" event, the Community Development function of the Federal Reserve is working to bring those voices to the collective table, and is positioned to do so through its mission and its relationships with a broad array of stakeholders. ■

On the reel



There was some heated disagreement at the Cleveland Fed's seminar, "Getting Back in Gear: Better Ways to Move Stalled and Vacant Foreclosures Forward," in March. We ask the Cleveland Fed's Tom Fitzpatrick to explain why emotions ran high, and where most groups' interests tend to align. Watch now: www.clevelandfed.org/fff/ZombieProperties/

Did you know?



Sometimes, nobody—not even a lienholder, such as a bank—wants to take possession of an abandoned property. Read "The Face of a Policy Issue." <http://tinyurl.com/qz03y2x>

Tweet us



How do you see the challenge of vacant foreclosures abating or continuing to impact your community? Tweet us @ClevelandFed. Use the hashtag: #zombieproperties

Running out of Options? One Outlook for the Long-Term Unemployed

The long-term unemployed are people who have been jobless for 27 weeks or more, as defined by the Bureau of Labor Statistics. There were 3.2 million long-term unemployed Americans as of July, or 33 percent of the total of 9.7 million unemployed. Over the past year, the number of long-term unemployed has declined by more than a million people, but stories of hardship still abound. Loss of housing, retirement savings, healthcare, and more are all fears or, worse, realities. To learn more about the realities and the outlook for these people, *Forefront* talked with the Cleveland Fed's Bruce Fallick, an expert in labor markets and displaced workers.

Forefront: *Why are so many people still unemployed, and for so long?*

Fallick: As I see it, the main thing is that the macroeconomy is not yet fully recovered; there are simply not as many jobs available as our workforce needs. During the recession, the unemployment rate peaked at 10 percent, which is very high, and has come down painfully slowly. There may also be some structural problems, such as a mismatch of skills and demand, but I don't think that's the main problem at this point. For one thing, long-term unemployment remains elevated pretty much across the board: across age groups, industries, and education levels.

Forefront: *It's generally agreed that the longer someone is unemployed, the harder it becomes for them to find a job. Why do you think this is?*

Fallick: All else equal, employers do seem to prefer people who are currently employed or who have been unemployed for a shorter duration. I think this is partly because they can't know why someone has been out of work for so long. For instance, have you been out of a job for months or years because you're an unproductive worker—or because of the luck of the draw? Some employers prefer not to take a chance.

There are analysts who think that being unemployed for a long time hurts your skills. I personally don't believe that happens often. It doesn't make you a worse worker because you've been out of work. But some employers believe it does, and that is another reason why they might choose not to hire someone who has been unemployed for a while.

Forefront: *What is your outlook for the long-term unemployed? Do you see hope for these people?*

Fallick: Historically, in the US, long-term unemployment has not remained a major problem once the overall economy has recovered from a recession. So I'm hopeful that the skills of the long-term unemployed have not been seriously compromised and that, as the macroeconomy recovers more fully, employers will start hiring more of them.

But we've never before seen such high numbers of long-term unemployment—or such long durations among the long-term unemployed—in the post-war period, so things could be different this time.



Forefront: *In her June 2014 press conference, Federal Reserve Chair Janet Yellen said that while she expects both the long-term unemployed and discouraged workers who are out of the labor force to be drawn back in again eventually, "it is conceivable that there is some permanent damage, to them, to their own well-being, their families' well-being, and the economy's potential." How would you respond to this?*

Fallick: The longer you're unemployed, the more options you run out of. You can run down your savings. Go into debt. Lose your housing. And that's not just homeowners. There is a lot of conversation about people losing the homes they own, but another conversation we should be having more often is about renters who can no longer afford their rent. The damage to the economy's potential comes if the long-term unemployed find themselves permanently shut out of the labor force.

Forefront: *Where do you think the government should focus its efforts when it comes to helping out unemployed Americans?*

Fallick: I think the main focus should be on steps that will improve the health of the economy generally. That includes steps that may not be obviously connected to unemployment, like tending to the country's fiscal health and investing in infrastructure. Getting the macroeconomy into better shape is really what's going to help unemployed Americans the most.

Forefront: *What about in the short term? There has been a lot of debate over how long unemployment compensation should last.*

Fallick: One thing I do suspect has helped many unemployed persons is Medicaid expansion. The expansion (technically called "Increasing Access to Affordable Care") ended the exclusion of low-income, childless adults from Medicaid coverage, and while we don't have data yet on how many unemployed workers have benefitted, the numbers overall are pretty compelling [see box below]. Not all states

have supported the coverage though. As of June, only 25 states have decided to move forward with the expansion.

Forefront: *What can the Federal Reserve do to help guide policymakers' decisions? Are there knowledge gaps that you can fill? Research you can conduct?*

Fallick: Yes, and we are. There is a lot of research being done around the Federal Reserve System pertaining to the causes and consequences of long-term unemployment. Here at the Cleveland Fed, we're doing research on outcomes for displaced workers, the impact of plant closings, workforce development, and mortgage foreclosures, among other topics. For example, we are collaborating with the Ohio Housing Finance Agency to evaluate a federal program that provides mortgage payment assistance to unemployed homeowners. The goal is to estimate the impact of this temporary mortgage assistance on the re-employment of program participants and subsequent housing stability. And, of course, we're conducting a lot of research on a macroeconomic level. ■

—Amy Koehnen

More on Medicaid

How many unemployed people have signed up for Medicaid following its expansion in more than two dozen states? It's hard to say, given the data available. However, it's clear that more people, period, are signing up.

The state of Ohio, which expanded the threshold for Medicaid as of January 1, expected that 366,000 people who had previously been ineligible for healthcare through the program would sign up by July 1, 2015.

By the end of July 2014, however, the state was already nearly there, with 338,707 newly eligible people signed up, according to the Ohio Department of Medicaid. The state did not have data about how many of those who've signed up are unemployed.

More broadly, a recent report from the Centers for Medicare and Medicaid Services reveals that the 25 states that had implemented the Medicaid expansion by June 2014 saw an increase of more than 18.5 percent in enrollments in Medicaid and the Children's Health Insurance Program for June 2014, compared to their average monthly enrollment in a July–September 2013 baseline period.

And states that had *not* implemented the Medicaid expansion by June 2014? They reported an increase of approximately 4 percent over the same baseline period.

—Michelle Park Lazette

Getting Our House in Order

US households are saving less and borrowing more than they did right after the Great Recession. But economists and others say balance sheets have improved, and that's good news for entire communities.





Michelle Park Lazette
Staff Writer

Many Americans continue to try to save more money than they did before the economic downturn, and they have less debt, too. Whether they're still saving and deleveraging as much as they did during and immediately following the maelstrom is another story.

Here's what has happened: American households—scared and reeling from the Great Recession—socked away more and deleveraged, or paid down debts.

The personal savings rate, measured as the share of disposable income that people save, rose to 6.7 percent in June 2009 (the official end of the recession)—more than double its 3 percent in December 2007 (the beginning of the greatest downturn since the Great Depression).

Decades ago, in July 1975, the savings rate topped 12 percent.

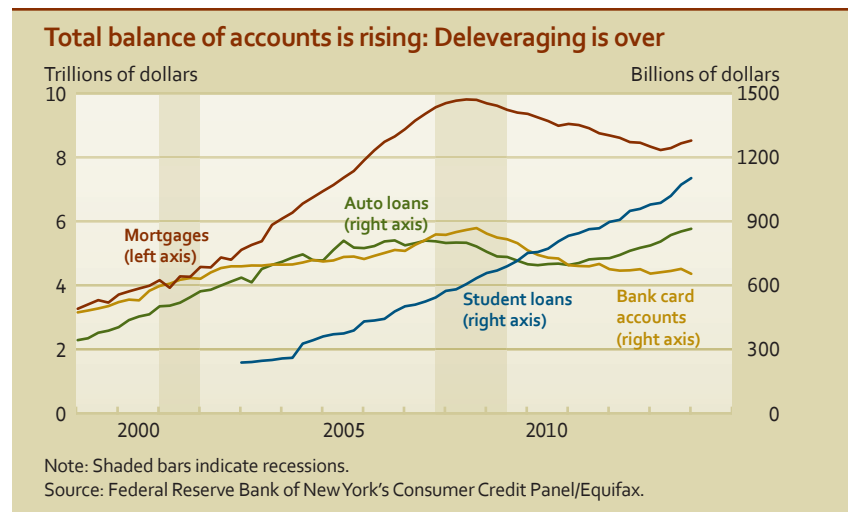
“During a period, mid-1980s through about 2007 or so, while savings were declining, our use of credit skyrocketed,” explains LaVaughn M. Henry, vice president and senior regional officer for the Federal Reserve Bank of Cleveland. “Basically, we became a nation of dis-savers. It was easier to expand our credit lines than it was to cut back on consumption.”

What resulted was trillions and trillions of dollars in household debt and a collapse of savings.

Following the recession, though, households curbed their borrowing sharply. Lenders contributed to the deleveraging, too, by tightening credit standards—which blocked some from borrowing even if they wanted to—and by charging off bad loans.

Specifically, from the third quarter of 2008 through the second quarter of 2013, total household debt, which includes mortgages, credit card balances, student loans, and auto and other debts, fell for 17 of 19 quarters.

Now, nearly six years later, here's what is happening: Debt is rising again. Total household debt has increased for the past three quarters, reaching \$11.7 trillion, according to research published on July 1 by the Cleveland Fed's Emre Ergungor, assistant vice president and economist, and Daniel Kolliner, research analyst. That \$11.7 trillion figure remains 7.9 percent lower than household debt's peak of \$12.7 trillion in the third quarter of 2008.



And while the savings rate actually rose from 4.1 percent in December 2013 to 5.7 percent this July, it's down from its December 2012 peak of the past decade of 10.5 percent, according to the Federal Reserve Bank of St. Louis.

While low interest rates may de-motivate people from squirreling away their money for marginal profits, the rates are not likely the primary driver of the recent decline in savings, Henry asserts. If low rates were the driver, then savings rates should have declined, not increased, during the recession, when rates were at historic lows.

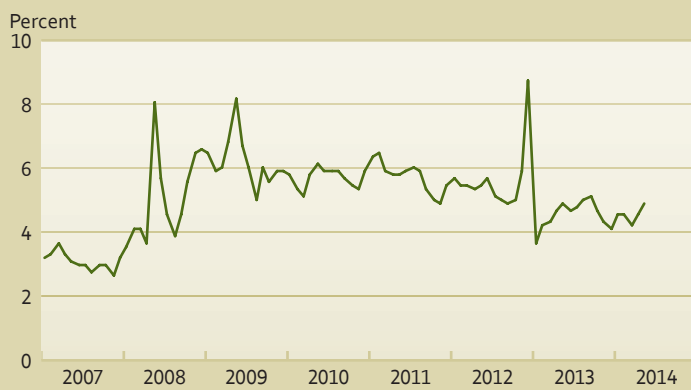
Does our saving less than we did right after the recession indicate the American public didn't learn from the recession? No, Henry says.

“Income levels have been very stagnant in this country for at least the last 10 to 15 years; nonetheless, the cost of living continues to rise,” he says. “But yet, we’re still saving a greater percentage (than before the recession). What that implies to me is that we have learned.”

Striking a balance

Consider, for one, the household debt service ratio, which is tracked by the Federal Reserve Board, Henry says. The ratio of total required household debt payments to total disposable income had climbed to 13.18 percent by the fourth quarter of 2007. In the first quarter of this year, it registered 9.94 percent.

The personal savings rate spiked in 2012 and has dropped since



“When was the last time we saw 9.94 percent since 1980? Never,” Henry reveals. “That’s the lowest it’s been since this ratio started to be measured in 1980.”

“My point is, the ability of households to support debt service is much better now than it’s been in 30 years,” Henry adds. “We have gotten, and continue to get, our personal financial houses in order. We’re saving more with an eye toward increasing our consumption for the long run, while not burdening ourselves with substantial debt in the short run.”

“We also have to recognize that while we want to promote saving, there is a cost in the short term,” Henry notes. “More saving means lower consumption, and lower consumption means slower economic growth. It’s a fine balance.”

Whether debt continues to climb as it has in recent quarters depends on another balance—between supply and demand—says the Cleveland Fed’s Ergungor. If consumers are to borrow, they need willing lenders; they also need to believe their income growth will bear the cost of whatever debt they might assume. In the case of home equity loans and lines of credit, they need home equity, too, which dropped significantly during the foreclosure crisis.

On the lender, or supply, side, it’s a question of how much income growth lenders expect in the future and how much lenders believe households can sustain. There’s also the changing regulatory cost of lending, Ergungor explains.

By most accounts, household deleveraging seems to be over, say Ergungor and Kolliner, pointing to how auto and student loan lending have been strong throughout the recovery and the way mortgage lending is beginning to turn the corner.

But when they calculate the same data in inflation-adjusted terms (paying like it’s 1999), they find that mortgage balances, which in **nominal** terms are up to their 2007 level and increasing, are still flat at their 2005 level. And while recent growth in auto loan balances looks strong in nominal terms, the balances still lurk below their pre-crisis peak in **real** terms.

While some studies show a reduction in household debt, executives with Neighborhood Housing Services of Greater Cleveland, which provides programs and services to help people achieve and sustain homeownership, see alarming levels of student loan debt and unsecured debts such as payday loans, says David Rothstein, director of resource development and public affairs.

Nominal interest rate: Interest rate, before taking inflation into account. Put another way, nominal interest rate = real interest rate + inflation rate.

Real interest rate: Interest rate that has been adjusted to remove the effects of inflation to reflect the real cost of funds to a borrower and the real yield to a lender.

“From what I can gather from our clients, both qualitatively and quantitatively, our clients’ wages are down,” says Rothstein.

“Wages are down and benefits are less—healthcare and retirement,” he adds. “What that tells us is it’s going to be harder for families to get by when the main income coming into them is less than it was before. (And) it seems to me that there are a lot of things that have not gone down in price. So, when your wages are down, and the other costs have gone up since the recession, it makes budgeting very challenging.”

In fact, 24 percent of Americans have no emergency savings at all, according to the Financial Security Index poll for June by Bankrate, a leading aggregator of financial rate information.

More plain vanilla, please

Why should those who *can* save and *can* borrow care that others cannot? Sources say the potential fallout of the inability of others to save and borrow is not limited to single households, but instead can pervade entire communities.

Indeed, that very fact is one takeaway of the housing crisis, says NHS of Greater Cleveland’s Rothstein.

“One thing we quickly learned from the (foreclosure) crisis: Your neighbor’s pocketbook can really impact the entire block,” he says. “If that house goes into foreclosure, it makes it harder for you to sell, makes it harder for you to get cash out of your house.

24 percent of Americans have no emergency savings at all.

“The same thing applies to savings,” Rothstein adds.

“If people’s ability to fully participate in the economy is inhibited by a bad balance sheet, that’s going to impact the community and the broader economy.”

All of us are subject to income shocks, notes the Cleveland Fed’s Ergungor.

“You may lose your job, your significant other may lose his or her job,” he says. “Credit is one way to smooth consumption, or savings is one way to smooth consumption, so you don’t lose your quality of life for a short duration of unemployment.

“You want people to be able to live through a short episode of unemployment without neglecting their houses, or, in the extreme, without being forced to vacate their property,” Ergungor adds.

Some say there is more to be done to bolster household balance sheets. The Cleveland Fed’s Henry believes the Fed can work to further spread financial literacy so more people understand how to save and why it’s important.

Rothstein’s recommendations begin with increasing people’s access to “more plain vanilla savings accounts” so that it’s easier to open and maintain one. (NHS execs have noticed a decline in the number of banks that offer stand-alone savings accounts, he says.) He also advocates a less arduous process for buying savings bonds. ■

On the reel



The numbers say that households are borrowing more than they did after the Great Recession. But everyday Americans told us a different story. Watch *Forefront’s* latest Man on the Street video:

www.clevelandfed.org/fff/HouseInOrder

Tweet us



From your perspective, what are ways to strengthen household balance sheets? Do you have best practices that have worked for your own finances? Tweet us @ClevelandFed. Use the hashtag: #householdfinance

Municipal Bankruptcy's Tug-of-War

When a municipality files for bankruptcy under Chapter 9 of the US Bankruptcy Code, questions abound: How does federal bankruptcy law intersect with state laws? And are modifications to pensions permitted to allow a city to make a fresh start?



Laura A. James
Attorney

The often-misunderstood process and unpredictable outcomes of municipal bankruptcy cases create uncertainty for all involved. But as more municipalities are faced with increasingly higher unfunded public-pension liabilities, taxpayers, public sector employees, and retirees should be concerned about which law—state or federal—rules in bankruptcy court and how court rulings may set legal precedents for who gets paid, how much, and when.

Here at the Cleveland Fed, we're interested, too. Conceived in 2011, the Public Pension and State and Local Government Financial Monitoring Team, or Muni FMT, has been following developments in municipal finance. Our goal: a better understanding of how issues of state and local government finance might affect not only municipal bond investors and public sector employees and retirees, but also the stability of the broader financial system.

At the center of the current debate on municipal bankruptcies is how federal bankruptcy law supersedes state law. Two recent high-profile cases—in Stockton, California, and Detroit, Michigan—have shed light on whether certain pension obligations protected by a state's constitution can

be modified through Chapter 9 bankruptcy. Though there is no final determination as to how pension obligations will be treated in specific municipal bankruptcies, if the initial outcomes of these cases are any indication, federal law allowing for the impairment of pensions may prevail.

The law of the land

The 10th Amendment to the US Constitution reserves certain powers to the states, but this autonomy is moderated by two clauses in the Constitution. The Supremacy Clause dictates that federal law is the supreme law of the land, notwithstanding state laws to the contrary, while the Uniformity Clause authorizes Congress to enact uniform bankruptcy laws.

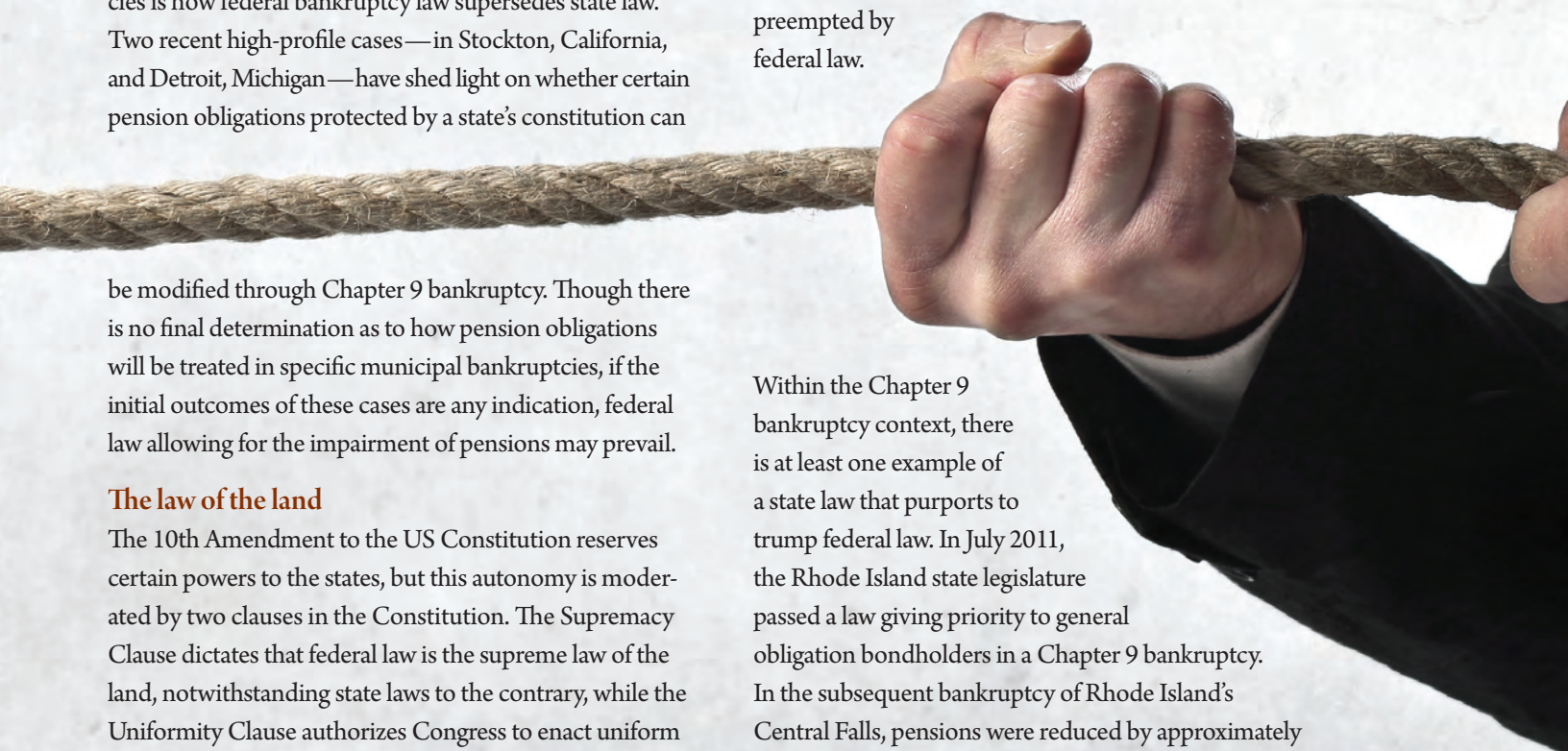
It seems that the combined power of the Supremacy and Uniformity clauses would leave little room for conflict over bankruptcy matters. Not surprisingly, several court cases have concluded that when a state law conflicts with federal bankruptcy law, the state law is preempted.

For example, in *County of Orange v. Merrill Lynch & Co.*, the court settled a dispute as to whether a California statute was applicable in the county's bankruptcy case, despite the fact that it contradicted federal bankruptcy law. The state statute attempted to create a special class of creditors who would receive priority, which was in direct conflict with the priority scheme set forth in federal bankruptcy law. The court held that to the extent the California statute conflicted with the priority scheme set forth in federal law, it was preempted.

The law of the state

Despite the fact that the Supremacy Clause and the Uniformity Clause seemingly prevent states from creating their own creditor-priority schemes in relation to municipal bankruptcy, the Supreme Court has held that federal law does not preempt all state laws in other contexts. For example, state environmental laws, foreclosure laws, and bona fide purchaser statutes have been held not to be preempted by federal law.

Within the Chapter 9 bankruptcy context, there is at least one example of a state law that purports to trump federal law. In July 2011, the Rhode Island state legislature passed a law giving priority to general obligation bondholders in a Chapter 9 bankruptcy. In the subsequent bankruptcy of Rhode Island's Central Falls, pensions were reduced by approximately 55 percent, while general-obligation bondholders received 100 percent of what was owed. The constitutionality of this law remains to be seen as a lawsuit challenging the law is pending in Rhode Island.





The Stockton Bankruptcy

Stockton filed for bankruptcy in the spring of 2012. The bankruptcy judge ruled that Stockton was eligible to file for bankruptcy, over the objection of the city's largest creditor, the California Public Employees' Retirement System (CalPERS). CalPERS challenged the filing despite the fact that Stockton was not proposing to impair pensions and vowed to keep making its required payments to CalPERS. California state law requires members of CalPERS to make regular payments to the pension fund; federal bankruptcy law arguably allows municipalities to renegotiate their contracts to reduce pension obligations.

The judge overseeing the Stockton bankruptcy has made his view clear—federal bankruptcy law trumps state law. Judge Christopher Klein's comments in the Stockton bankruptcy makes it evident that he could impair CalPERS's contract rights and is unconvinced that California state law protects public pensions over the claims of other creditors. An October 2014 date has been set for Judge Klein to hear arguments over the legal status of CalPERS's claim.

Even if it is determined that Stockton is legally allowed to impair its pension obligations to CalPERS despite the California constitutional protections, city officials will be forced to consider whether Stockton will impair pensions in its final plan of adjustment. Although Judge Klein has openly stated that the city could impair pensions, Stockton has proposed a final plan of adjustment that does not include any cuts to pensions. Currently, Stockton is in the midst of a legal battle over an objection from a bondholder that would recover only 1 percent of what it is owed, while pensioners would get 100 percent. Thus, at this time, it is unclear whether or not the court will be forced to address the issue squarely.

Stockton

Lessons learned from Stockton and Detroit

The Chapter 9 bankruptcy filings of Stockton, California, and Detroit, Michigan, continue to shed light on how the 10th Amendment, Supremacy Clause, and Uniformity Clause (and other state-specific laws and state constitutions) can affect both a municipality's eligibility for bankruptcy and the order in which creditors are paid.

Several creditors, in fact, have relied upon the 10th Amendment to contest the eligibility of these cities to file Chapter 9 bankruptcy. Regarding the order in which creditors are paid: On the one hand, those who oversee pension funds argue that there are state constitutional protections preventing cities from impairing pensions. On the other hand, bondholders argue that federal bankruptcy law should trump various state constitutional provisions that protect pensions from being reduced, so that the priority-of-payment scheme set forth in federal law would apply uniformly.

What's at stake

In all bankruptcy cases, whether or not vested public pension benefits are impaired, some creditors "win" and some creditors "lose." On the one hand, while the plight of pensioners usually makes headlines, most municipal bonds are held by individual investors, many of whom hold them as part of their retirement planning. In fact, US households hold \$1.6 trillion, or 44 percent, of the nearly \$3.7 trillion in outstanding municipal bonds. Mutual funds hold an additional \$1 trillion, or 27 percent, of these bonds. On the other hand, public employees were promised these benefits and may have accepted lower salaries during their careers or saved less for retirement in private accounts based upon those promises. Moreover, there is no universal pension insurance scheme for public pensions, as there is for private pensions, and many public employees are not eligible for social security.



The Detroit Bankruptcy

Detroit's experience is similar to Stockton's. Before Detroit filed for bankruptcy, several state-court lawsuits were filed by Detroit's creditors to prevent the city from even being able to file for bankruptcy protection. Detroit's pension funds relied upon a state constitutional provision that prohibits pensions from being impaired, arguing that the mere filing for bankruptcy protection allowed for the potential for pensions to be impaired.

The federal bankruptcy court determined that Detroit was in fact eligible for bankruptcy. With this ruling, creditors' arguments that relied on the state constitutional provision which they claimed made pensions impervious—incapable of ever being reduced—were rejected. Similar to Judge Klein's comments in the Stockton bankruptcy case, Judge Steven Rhodes in Detroit stated that bankruptcy is the business of impairing contract rights. The judge went so far as to comment in his eligibility ruling that the bankruptcy court had the power to impair public pension benefits.

Detroit's emergency manager submitted a plan of adjustment that was approved in July by a majority of the city's creditors, including pensioners. The final plan of adjustment provides for comparatively small cuts to pensions so long as pensioners vote in favor of the plan. The city is also working to finalize agreements with public sector employees that will result in some reductions in pension and healthcare benefits, but whether the judge approves the reductions will be determined when the bankruptcy trial that is scheduled to begin in September concludes.

Detroit

The choices municipalities make with their money may have an even further reach than individual pensioners or investors; a municipality's ability to continue providing the basic services could also be at risk. While the obligations a municipality has to its residents and tax base do not disappear with a Chapter 9 bankruptcy filing, if the municipal entity is overly burdened repaying prior obligations, it may simply be unable to provide basic services. This could lead to further erosion of its tax base, continuing a downward spiral.

Despite unanswered questions about how Chapter 9 bankruptcies will play out in the courts, municipalities that are faced with dire financial conditions have the chance to get a fresh start—to readjust debts in order to provide for residents and obtain long-term financial stability. ■



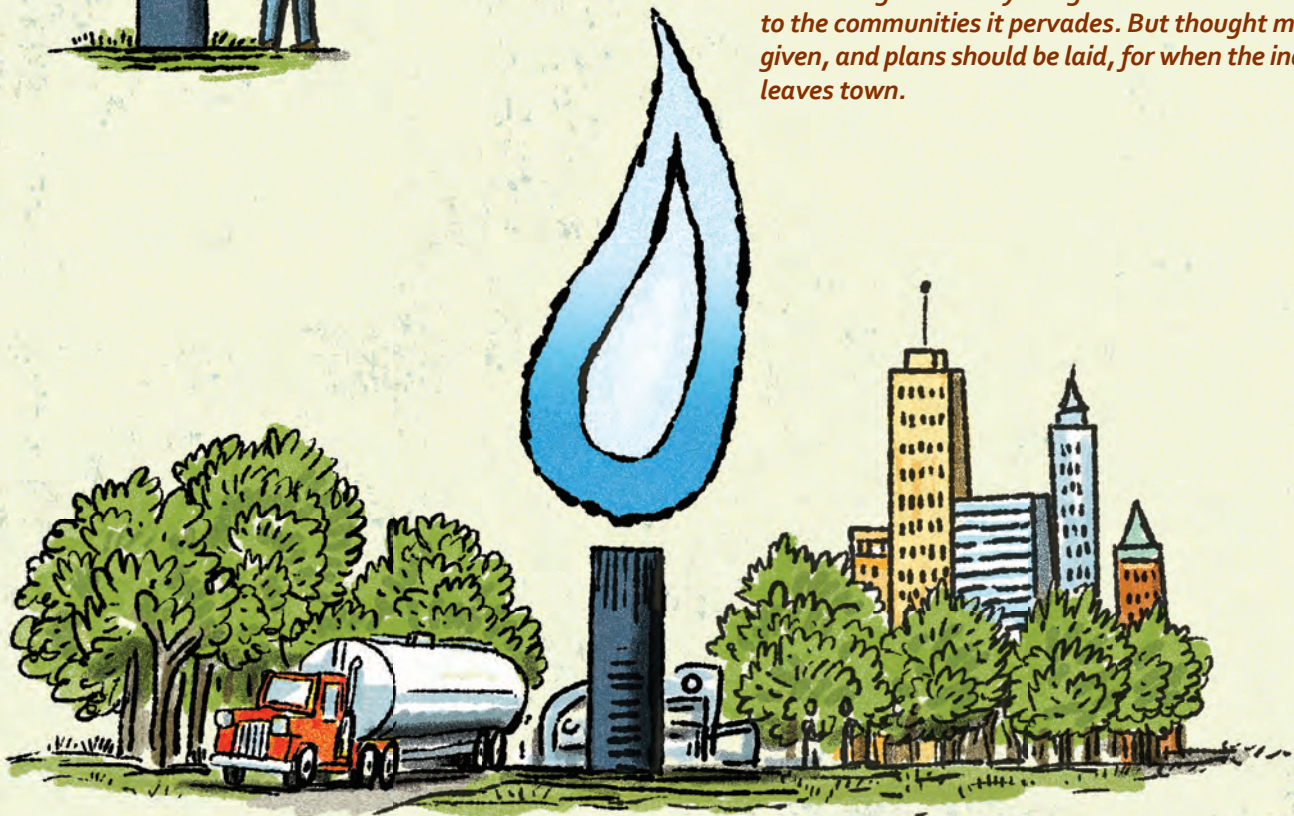
On the reel

Pension obligations could drain money for municipal services, such as fire, police, and education, according to several experts who spoke at the Cleveland Fed's 2013 conference, "Public Pension Underfunding: Closing the Gaps." One speaker even says broader economic growth could be squeezed: www.clevelandfed.org/ff/MuniBankruptcy/

Deep Wells, Deep Pockets, and Deep Impact



The shale gas industry brings both costs and benefits to the communities it pervades. But thought must be given, and plans should be laid, for when the industry leaves town.



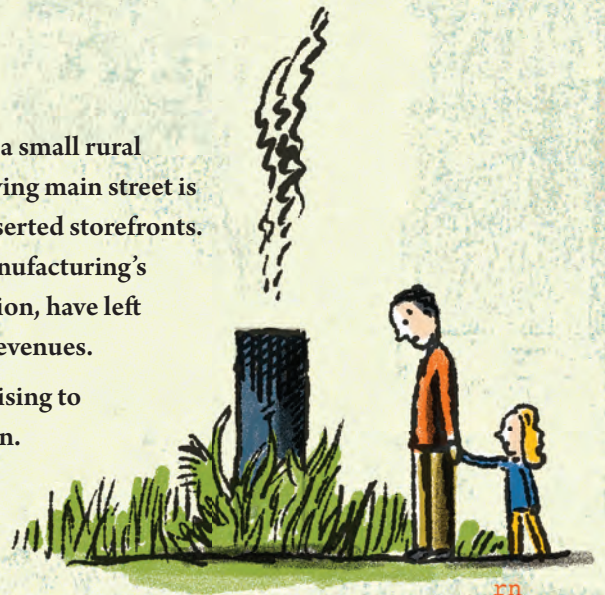
Matt Klesta
Research Analyst

Imagine: You live in a small rural community. Its once-thriving main street is now pockmarked with deserted storefronts.

Its population, steadily dwindling. Its factories, shuttered by manufacturing's decline. These problems, badly exacerbated by the Great Recession, have left your town reeling from high unemployment and shrinking tax revenues.

Now imagine that an industry with deep pockets walks in, promising to create jobs, replenish city coffers, and build wealth in your region.

If this sounds too good to be true, it's because it just might be.



rn

These promises—coming from the oil and gas industry—have a price. In exchange for jobs, tax revenue, and wealth creation, the community must cope with costs like increased traffic, the potential for more expensive housing, and the risk of environmental degradation; combined, they can change the dynamics of the community.

What's to be done?

Communities across the country increasingly face this dilemma as the oil and gas industry, using new technology, has been aggressively pursuing previously unrecoverable deposits and igniting a boom in shale gas. This has been especially true in parts of the region the Cleveland Fed serves. Ohio, Pennsylvania, and West Virginia—each state can claim communities at various stages of the extraction process. The breakneck speed at which this development occurs makes it all the more important for a community to consider the long-run implications before drilling begins.

Immediate impact

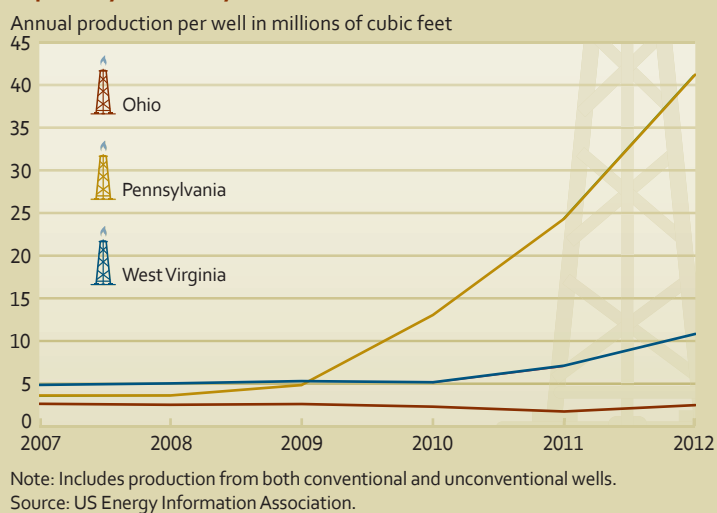
Drilling for oil and gas is not necessarily new to Ohio, Pennsylvania, and West Virginia, where thousands of conventional wells have been drilled since the mid-1800s. What is new is that the rate of drilling and volume of production have increased dramatically since unconventional drilling began a few years back (see figure 1). For example, a conventional vertical well produces around 250 cubic feet of natural gas per day. A hydraulically fractured well, though exponentially more expensive, produces four to five million cubic feet per day.

Costs. Although increased production is a boon for the oil and gas industry, it subjects communities to more concentrated, intense drilling than ever before. For example, a shale gas well typically requires hundreds of trucks to ferry water, sand, pipe, and other supplies back and forth. This traffic rapidly degrades roads and bridges, congests streets, and increases the risk of accidents.

Often, outside of states such as Texas and Oklahoma, which have historically been centers of oil and gas drilling expertise, a region's workforce lacks the skills the industry requires. Out-of-state workers must be imported, filling hotels, campgrounds, and the few available rental units. In rural communities, the increased demand for scarce rentals may raise rents, pricing current residents out of the market.

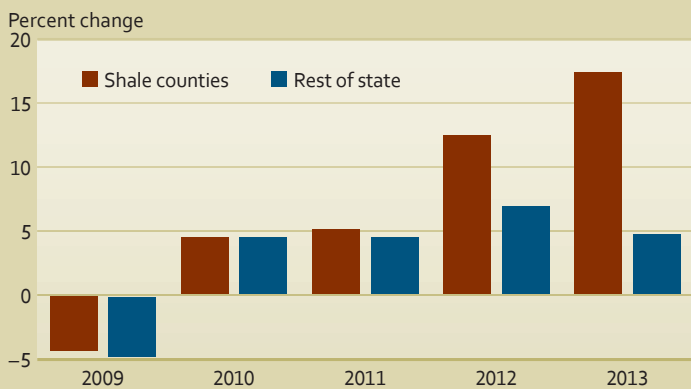
In addition, nearby residents may experience noise, light, air, and water pollution: Drilling occurs around the clock, exposing communities to the din of diesel compressors and intensified light at night. In certain circumstances, natural gas may be flared off and burned, and large amounts of the water, sand, and chemical mixture used in the hydraulic fracturing process may eventually be stored on-site in large retention ponds with the potential to leak.

Figure 1: Natural gas production has exploded in recent years, especially in Pennsylvania



Benefits. The increased production can also be a boon for some community residents. The terms for leasing mineral rights typically include a signing bonus and a royalty percentage awarded to landowners, based on the volume of oil and gas recovered on the property. According to a case study of Carroll County by Policy Matters Ohio, signing bonuses could be up to \$5,800 per acre and royalty payments to at least 12.5 percent. Landowners, some of whom became millionaires overnight, are paying off mortgages and buying farm equipment and other durable goods.

Figure 2: Growth in sales tax revenue in Ohio shale counties easily surpasses the rest of the state



Source: Ohio Department of Taxation.

The influx of workers from outside the region fills local restaurants and hotels and can create new businesses or enable existing ones to expand. This beefed-up purchasing can bolster sales tax revenues, and the leasing of land by cities and school districts can ease tight budgets. Figure 2 shows the change in sales tax revenue for the eight Ohio counties where most of the state's drilling occurs, compared with the rest of Ohio. Even though the eight counties accounted for only 3.8 percent of the state's total revenue in 2013, that share was 0.6 percentage points larger than four years earlier and has been increasing at a faster rate since 2012.

Longer-term implications

Two specific issues have the potential to jolt a community in the long run: the boom–bust cycle and what is known as the natural resource curse. Because the supply of shale is finite, it tends to create a boom-bust cycle with three stages: First, a flurry of activity as drilling begins and infrastructure is built. Next, a period of slower development as drilling slows while production plateaus and enters a maintenance period. And finally, the bust, when production stops and the industry moves out of the region.

The natural resource curse is the tendency for a region's strong dependence on one industry to crowd out investment in others. It also increases economic volatility as the region is tied to the success of a single commodity, such as coal, oil, or natural gas and subject to international price fluctuations. For example, the presence of the oil and gas industry may move investment into industries that

supply the products it needs; the well-paid jobs it offers may induce workers to migrate out of other industries. The problems arise when the dominant industry exits the region, leaving behind underdeveloped industries and few job opportunities for the newly unemployed workers.

What can a community do?

An extensive body of literature has examined the impact of natural resource extraction on communities from many angles: sociologically, economically, environmentally, and politically. Impacts vary among regions, each managing its economic development in its own way. That said, the literature suggests next steps that are applicable to most regions. For one, communities need to consider the industry's likely long- and short-run impacts.

In the short run. Joe Campbell, a research associate at the Ohio State University Extension, recently examined how communities in Jefferson County, Ohio, are coping with short-run growth in shale drilling as the early flurry of leasing slows and drilling begins. There, it has been important to identify the key players who will be affected by the growth and to convene regular meetings among them. Players include elected officials, business leaders, citizens, and community groups.

Other lessons learned are the importance of understanding that the oil and gas industry moves quickly and is dependent on global prices, not necessarily on local concerns. However, it is still important to engage regularly with industry representatives, ideally with a united community voice, to understand their plans and cultivate a relationship that may help the community in the future.

In the long run. Planning for the long run is more difficult. A community's resources tend to be stretched during the boom, leaving little time to plan for the future. The unpredictable length of the boom also introduces uncertainty about how far ahead the community needs to plan. Communities would benefit from thinking about how they can retain wealth from the natural resource boom and to prepare for life after the drilling and extraction ends. One approach is for communities to develop ways to diversify their economies so that the oil and gas industry's departure does not lead to a mass exodus of population and capital, leaving communities with expanded and underutilized infrastructure to maintain.

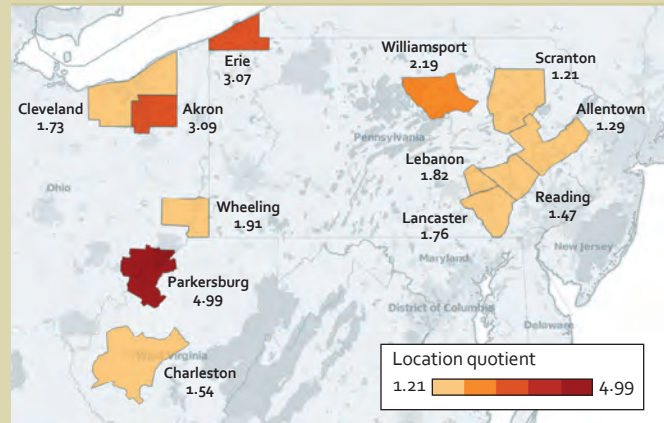
Another idea that has already had some success is to develop programs to teach residents the skills they will need for relatively high-paying jobs in the oil and gas industry. One regional program that facilitates this effort is ShaleNET, which was developed at Westmoreland County Community College in southwest Pennsylvania using a \$5 million grant from the US Department of Labor.

ShaleNET consulted with the industry’s major employers to develop a curriculum that fits their hiring needs. This highly regarded program has since expanded to include four community colleges in three states (Ohio, Pennsylvania, and Texas). According to its website, ShaleNET has trained more than 5,000 participants, 3,400 of whom have found employment. Given the uncertainty about the lifespan and labor requirements of the shale boom, entities like ShaleNET must be nimble enough to adjust their programs to meet the industry’s needs.

Another approach is to establish a future fund, at the state level, that will tax the industry according to the volume of gas and oil extracted, setting the proceeds aside for economic development, environmental remediation, and re-energizing a community’s economy after the boom ends. An example is North Dakota’s Legacy Fund, which, as of April 2014, had a balance of nearly \$2 billion. This fund will continue to accumulate until June 2017, when state lawmakers will decide how to utilize it. Currently, Ohio is considering changes to the structure of its oil and gas taxes, which would set aside a small percentage to create a legacy fund for use after 2025.

Lastly, a region may capitalize on existing industries’ ability to take advantage of the proximity and range of chemical components that can be extracted and used in the chemical and plastics manufacturing industries. Several of the region’s metropolitan areas (see figure 3) have above-average employment in those industries, and expanding them may help to retain more wealth in the region. It is still too early to tell how much these industries in the region will benefit.

Figure 3: MSAs with high levels of chemical, rubber, and plastics manufacturing employment may be better able to retain wealth



Note: Location quotients based on average employment from 2001 to 2012.
Source: Bureau of Labor Statistics.

Infrastructure to transport gas is still being constructed, and decisions about processing facilities are still being made. However, Ohio’s economic development agency is working with a local university to better understand how the shale gas boom can leverage the region’s expertise in plastics and chemical manufacturing.

Over the next year, the Cleveland Fed will host roundtables in communities across southeastern Ohio and southwestern Pennsylvania, where the oil and gas industry has been most active. Our purpose is to begin a conversation among key stakeholders that will continue as the impact of the oil and gas industry matures. ■

Online exclusive



All this oil and gas production can revitalize communities, and so, too, can anchor institutions, says one known expert on community wealth building. Ted Howard of the Democracy Collaborative says such anchors—generally large, place-based, nonprofit institutions (for example, hospitals and universities)—can take purposeful action to benefit neighborhoods, but there can be unintended consequences. Read the *Forefront* interview: www.clevelandfed.org/fff/Howard

Tweet us



Because the supply of shale gas is finite, it tends to create a boom-bust cycle. How do you believe communities could handle the boom and the bust? Tweet us @ClevelandFed. Use the hashtag: #shaleboom

Measuring America

Interview with Erica Groshen

Commissioner
US Department of Labor,
Bureau of Labor Statistics

The commissioner gives
Forefront the stats on inflation
and unemployment, and the many
hands it takes to produce them.



Few data sets are tracked more closely than those on inflation and unemployment, with journalists, economists, households, and others marking the release dates on their calendars. But before the estimates are published and appear in the nightly news reports, data must be collected, analyzed, and disseminated. Since 1884, the Bureau of Labor Statistics (BLS) has been doing just that.

The Senate confirmed Erica Groshen as the 14th BLS commissioner in January 2013. She is steeped in research and statistics knowledge, having come through the Federal Reserve System and having served on advisory boards for the BLS and the US Census Bureau.

Groshen was a speaker at the Federal Reserve Bank of Cleveland's inaugural conference on Inflation, Monetary Policy, and the Public on May 29–30, 2014. Cleveland Fed Research Director Mark Schweitzer, who is Groshen's former colleague, interviewed her after the conference. An edited transcript follows.

Schweitzer: Skeptics often ask us why the public should have confidence in our inflation measures. How would you answer them?

Groshen: We at the BLS collect the information in ways that are designed to be accurate.

We have on-staff statisticians who have a huge amount of expertise to help us design exactly the right way to measure inflation. We do it in an open and transparent way, so all our methodology is completely open to public scrutiny. Reporters occasionally come with us into the field so that they can understand how it is we do what we do.

We are also an agency that is independent of the political process. I am the only person at the Bureau of Labor Statistics who has a presidential appointment, and I am appointed for a set term. Everybody else at the BLS is a professional civil servant. We operate in this independent way according to the principles set up for the National Statistical Agencies by the Office of Management and Budget. All of these steps that we take are intended to make sure that the public can trust us and our measures.

Schweitzer: What is the difference between inflation and the cost of living?

Groshen: I think it really comes down to the cost of living being a personal concept. It's something experienced by people. It's going to be different from person to person, but you can get an average across people. It's still ultimately how you experience price changes on a personal basis, whereas inflation is really more of a theoretical concept. It is the part of price changes that is driven by monetary policy. And there's clearly a relationship between the two of them, but they don't have to be exactly the same; certainly, you wouldn't expect them to be the same from person to person.

Schweitzer: What do you think is the public's most frequent misunderstanding regarding the Consumer Price Index (CPI) or other inflation measures?

Groshen: One thing that I hear fairly often is "Why did you take food and energy out of the CPI? Those things matter to me!" I heard that just a couple of weeks ago. This is always surprising to me because the full CPI does include the influence of food and energy prices, but because different people have different things that they use our inflation measures for, we give them the information that they need to make indexes that are appropriate to the questions that they have. Some people want to understand underlying inflation trends and so they would like to look at what's happening to the part of the CPI that isn't being determined by the highly volatile food and fuel prices.

Schweitzer: *The chained CPI is getting a lot of attention. Can you describe this measure and its advantages?*

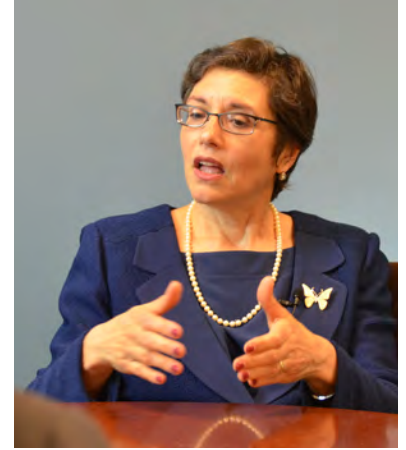
Groshen: Sure. It helps to contrast it with the regular CPI—the CPI-U (Consumer Price Index for All Urban Consumers). They are the same in that they use the same market prices. They differ in that the weights that are used for the chained CPI-U are for the same two months for which we are comparing prices, and the weights for the CPI-U are much older. In an inflation measure, the market basket is important because it determines how you weight different price changes. So if it's a large part of your market basket, then you weight that price change highly, and if it's a small part, you weight it less. The chained CPI and the CPI-U use the same set of weights, but for the chained CPI, we use ones that are much more current. So in the final chained CPI, we use the weights that are concurrent with when we collect the prices, and that gives us a really important advantage. For one thing, if you have trends in what people are spending their money on, then we're going to be much more up to date.

The other part that concurrent weights help with is called “substitution bias.” Substitution bias is actually a fairly simple idea: In a market economy, people react to changes in prices, and that's how they make their decisions on how much to buy. That's a good thing, but imagine a world where there's no inflation at all and all you had were these changes in relative prices.

Let's say we estimate the cost of living at one point, then a little later we measure the cost of living again and, between these two points in time, we had some changes in relative prices. Some people would buy less of the things where the prices had gone up and buy more of the things where the prices had gone down. They would have changed their market basket between the two periods. When we don't change the market basket, then we're giving too high a weight to the goods whose prices have gone up and too little weight to the goods whose prices have gone down. So that would tend to overestimate inflation and make you think that inflation had actually gone up when inflation had stayed the same. The chained CPI, by using concurrent weights and then a formula that's designed to take advantage of using these concurrent weights, gets rid of the substitution bias.

Schweitzer: *Are there any disadvantages to using the chained CPI?*

Groshen: It takes us a long time to actually collect the information on the market basket. Turns out that's harder to do than measuring the prices. So our very first release of the chained CPI is an estimate, and it's not until two years later that we get the final measure of what the chained CPI was for the period before. That makes it difficult to use for some purposes, although there are some workarounds.



Schweitzer: *Can you tell me a little bit about current research at the BLS in your price measurement areas?*

Groshen: One huge effort that we have underway is redesigning the Consumer Expenditure Survey. The last time it had a total redesign was some time in the 1980s. Many things have changed since then, for instance, how people spend money and what kind of records they have of their expenditures. So we want to redesign this survey—which is fairly burdensome—to make it less burdensome and also make it as accurate as possible. It's been five or six years now that we've been working on what this redesign will look like. We brought in experts: We had a National Academy of Sciences panel to advise us on doing this, and they gave us recommendations. We now have a plan for the redesign. It's up on the web and people can take a look at it. It will use much more electronic data capture, which will make the information more accurate and less burdensome. So that's one effort.

We're also doing research on how to measure medical prices better. That's a challenge for us because, first of all, it's a large part of people's expenditures, so it matters. Also, there's a lot of innovation in that area, so we want to get that right. One form of innovation that's problematic for us is capturing

the cost of treating a disease when the treatment moves from things like surgery to medication or to physical therapy. The cost to a patient for a surgical treatment may be far greater than the cost of a pharmaceutical treatment. It's difficult for us, with our current set-up, to include those price decreases. So we are working on how to account for those variables.

Schweitzer: *How does the BLS collect data from the ever-changing set of possible purchases on the internet?*

Groschen: Items that are purchased on the internet have, like any other consumer purchase, a chance of being selected for our survey. As consumer spending patterns and methods change, we capture those in our Telephone Point of Purchase Survey, which is used to identify the establishments and web sites we will use to track the prices that consumers pay.

Schweitzer: *It's a challenging and changing retail world, and consumers are making use of the internet, so it's got to be accounted for.*

Groschen: I agree and we are.

We're also doing research on how to measure medical prices better. That's a challenge for us.

Schweitzer: *Do you have any data that the BLS thinks the public ought to be paying more attention to?*

Groschen: One thing I find very interesting is within the realm of a survey we call the Current Population Survey, which gives us the unemployment rate. We publish the gross flows information, and this very often helps us better understand what's going on in the labor market and why the rate has moved up or down.

For instance, in April, we had a fairly large drop in the unemployment rate, and that was not due to more people having jobs, but to fewer people being unemployed. The reason we had fewer people being unemployed was not because they had found jobs, but because we had an increase in the people that are out of the labor market. When you hear that, you might think "Oh, all these unemployed people gave up looking and exited the labor market." But if you look at the flows,

you'll find that it wasn't that we had this exit of people from the labor market. We actually had a lack of people transitioning out of the labor market into unemployment. That's what drove this. So we reported this in the release.

The next thing we want to know is why the numbers showed fewer people transitioning into unemployment. So the first thing we ask is what was unusual about this month.

Well, Easter was late, and so we ended up doing our survey before the holiday, when normally we do it after. What often happens at Easter is that a lot of people say "After Easter I'm going to start looking for my Fall job or the job that I'm going to have when I graduate." They don't start doing it before Easter because they know for a week they're not going to be around. Then

Erica L. Groschen

Position

Commissioner, US Department of Labor,
Bureau of Labor Statistics



Former positions

Vice president in the Research and Statistics
Group at the Federal Reserve Bank of New York

Visiting assistant professor of economics,
Barnard College at Columbia University

Economist, Federal Reserve Bank of Cleveland

Visiting economist, Bank for International
Settlements (Basel, Switzerland)

Education

University of Wisconsin-Madison, BA

Harvard University, PhD

our seasonal adjustment may have led to this expectation of people joining unemployment when they didn't. And if that's true, then next month or the month after, this effect is just going to go away. So it gives us a conjecture. It will be another few months before we see if it's true or not.

Schweitzer: *There are a lot of questions about unemployment and whether or not we're accurately representing everybody who's out of the labor market. What are your thoughts about using the unemployment rate versus the alternative measures?*

Groshe: We publish six different measures of labor market utilization. The headline number, which we fondly call U3 (on a scale of U1 to U6), has some big advantages. It's got the longest time series, so it's the most comparable over time and it's most comparable to what other countries publish, so you get better comparability to what other countries are doing. It's also based on fairly well-defined criteria: To be in the labor market, you must have looked for work within the past 30 days and be ready, willing, and able to work right now.

The other measures have different criteria. For instance, U6, which is the broadest measure, counts underutilized labor—anybody who says they want work, even if they haven't done anything to search for it in the last month. Now, they're clearly different from somebody who says they



don't want work at all, but there are different reasons why someone says they want a job but aren't looking for one. It's much more open to interpretation and problematic.

The other people whom we include in our U6 measure are those who are part-time for economic reasons. They are involuntarily part-time workers and they'd rather have a full-time job. So that is a measure of underutilization. U6 gives you a broader measure of unemployment.

The key thing about all of the measures is what question you're asking. Are you asking how far away we are from normal? Any one of them, U1 through U6, is going to tell you the same thing. They move almost exactly together over time. So it doesn't matter which one you look at if you want to know how far we are out of the recession, but it does matter if you want to know what the total amount of distress in the labor market is and you want to define it in a different way.

Schweitzer: *You've been BLS commissioner now for more than a year. What do you think the public ought to know about the BLS?*

Groshe: I think the first thing they should know is that the staff that I have the privilege of working with is made up of the most dedicated public servants that I think anybody would meet anywhere. They are totally driven by the mission of making sure that their fellow citizens know what labor market conditions are, what prices are, what productivity and working conditions are. It's just in the DNA of the BLS. So it's just an honor and a pleasure to be working with them.

The second thing they ought to know is just how important this information is to everybody in the country—that these data are the pure public good. If we didn't know what the unemployment rate was and what the inflation rate was, we'd have a lot more people arguing about the facts instead of discussing what they should be discussing, which is what the correct policy decision is, given those facts.

Our policymakers really need this information, and our households really need this information because they have to make the right decisions for themselves and their families. Our businesses need this information so they can make the right decisions for their prices, for their purchases, for where they locate their companies.

This is just really, really important information and we hear every day how much people value it. These data have this really important impact.

Let me go one step further. Most people don't realize that our surveys are voluntary, so the people who are responding to our surveys are performing a civic duty that everybody in the country benefits from. They trust us to keep their information confidential and it's protected by law. We have never given it up for any purpose, and it is used solely for our statistical mission. It's not used for any type of enforcement activity or programmatic use. It is only about the statistical purpose, and everybody in the country benefits. That's part of the reason we have the really high response rates that we do. We get response rates that are way higher than any private sector survey does because people understand that they're performing a public service. The respondents are helping everybody in the country every time that they do that because their experience is being represented well. And the only way their experience can be represented well is if they participate in our surveys. We are so thankful that so many of them do.

Our policymakers really need this information, and our households really need this information because they have to make the right decisions for themselves and their families. Our businesses need this information so they can make the right decisions for their prices, for their purchases, for where they locate their companies.

Schweitzer: At the BLS, what's your best seller?

*Groshe*n: Our best seller is the *Occupational Outlook Handbook*, which we put out every two years. It's a detailed listing of more than 300 occupations: the wages, the projected job growth for the occupations, what the duties involve, what the nature of the work is, and what the educational requirements are for the jobs. This is used by every secondary and post-secondary school in the country to give people career advice and by career counselors of all sorts. It's based on a survey we do—the Occupational Employment Survey—and most people don't realize the main information they use to make career decisions comes out of the Bureau of Labor Statistics.

Schweitzer: You started your career at the Federal Reserve Bank of Cleveland. What did you learn from your experiences here?

*Groshe*n: To be honest, when I came to the Cleveland Fed, I didn't know anything about monetary policy. I had been an empirical labor economist. I had studied a lot about the labor market and was keen to learn more, but I really didn't know anything about central banking and its relationship to the regional economy. I learned how important it is for the central bank to have a deep and close connection with the regional economy in order to understand how inflation and economic growth is manifested in the economy, and also so that they can have ongoing communication with the people in the region about the importance of the work of central banking.

Schweitzer: Thanks so much. ■

—May 30, 2014



On the reel

Watch clips from *Forefront's* interview with Erica Groshe
n: www.clevelandfed.org/ff/Groshe

Book Review



The Divide: American Injustice in the Age of the Wealth Gap

by Matt Taibbi
Spiegel & Grau, 2014

This book, our reviewer says, is not a comfortable read. It asserts that the selective leniency and corruptibility of the American judicial framework has created a rift in which fair and equitable treatment is no longer a right but a luxury afforded to a chosen few.



Reviewed by
Abigail R. Zemrock
Executive Communications Coordinator

Modern America is often characterized as a dog-eat-dog society. We pride ourselves on working harder, pushing further, and moving faster than any other nation on the planet, and we glorify independence and socioeconomic success above all else—to a highly competitive degree. Some might say that Americans who have “made it” show similarities to the alpha-predators of the natural world, having a ruthless, almost animalistic drive to win.

And for those who haven’t made it, well... where there are predators, there must be prey.

This is the two-sided ecosystem that Matt Taibbi lays out in his latest book, aptly titled *The Divide*. A former *Rolling Stone* contributor/journalistic watchdog, Taibbi has made a career out of exposing what he views as the carnivorous practices of Wall Street and the financial industry. He is

adept at peeling back his characters’ layers to expose them for what he believes them to be: gluttonous, self-involved, imperfect. And, all too often, downright corrupt.

Income inequality is a timely topic—debates about the minimum wage, the rising costs of higher education, and the like are making headlines almost daily. Taibbi tackles this subject in a unique way: by examining it under the lens of the American judicial system. His thesis is clear: The wealth gap and the justice gap have spilled over into each other, creating a complex, dual problem in which neither issue can be fully resolved without first reforming the other. This is the survival of the fittest taken to a new dimension, in which the affluent are buoyed by virtually unlimited oceans of wealth, while those without means simply struggle to stay afloat in the judicial system.

Taibbi's book offers contrasting examples of "justice" as it relates to both the poor and the privileged, and demonstrates two types of laws—the written and the unwritten. He explores the concept of "collateral consequences," the often unintended results of poor decisionmaking that have an uncanny way of snowballing. This concept may result in a multimillion-dollar severance package for one type of individual and financial penalties or even incarceration for another.

Roughly half the book is dedicated to those occupying the high end of the income curve. Taibbi assembles a laundry list of white-collar financial crime from the financial crisis of 2008–09. Fraud. Larceny. Falsifying records. Embezzlement. Tax evasion. Pick your poison, and Taibbi can show you a lineup of some of the major players in the financial industry during the meltdown—none of whom, he notes, were ever prosecuted or served any time for their alleged misdeeds.

Consider Taibbi's skepticism about deferred prosecution and non-prosecution agreements, tools that allow companies to continue operating during an investigation, while avoiding a criminal charge: "They often read like agreements hashed out in friendly meetings by likeminded legal colleagues from similar cultural backgrounds... exactly what they are." For corporate leaders, collateral consequences tend toward slaps on the wrist, golden parachutes, and soft landings.

While Taibbi's case against corporate greed is strong, his empathy and determination in telling the stories of the other side of the wealth curve are stronger. His portrayals of the "little fish" that wound up tangled in the unsympathetic net of the judicial system are compelling and heartbreaking. These are individuals desperately clinging to life at the bottom—and being routinely hassled for their efforts.

Taibbi notes that collateral consequences affect this group too, often manifested in seemingly endless court appearances, rapidly compounding fines or fees, lost jobs, and the struggle to make bail. What are often simple inconveniences for the upper class can mean financial ruin and scarring social stigma for those unlucky enough to be caught up in the dragnet—whether they are, in fact, guilty or not.

Through these firsthand accounts of life on the wrong side of the divide, Taibbi illustrates his view of how an unbalanced, corruptible justice system plays a key role in perpetuating and accelerating the downward spiral of poverty. He interviews a variety of subjects, but their stories are variations on the following theme: A poor neighborhood attracts a heavier police presence; overzealous policing results in higher levels of incarceration; more people in jail means fewer are working; and lower employment and lost tax revenue breeds even more poverty, more police, more down-on-their-luck people left wondering where things went wrong.

Have we reached the point where we are capable of criminalizing citizens who don't, or can't, achieve the American Dream?

At its most basic, *The Divide* is a story about rich people and poor people, a split society of winners and losers where fair and equitable treatment is no longer a right but a luxury afforded to a chosen few. On another plane, it offers a healthy criticism of the selective leniency and corruptibility of the American judicial framework that allowed such a rift to occur in the first place. And it poses a disturbing question: Have we reached the point where we are capable of criminalizing citizens who don't, or can't, achieve the American Dream?

The Divide is not a comfortable read—Taibbi's reporting reveals shocking inequalities that are likely to sink your faith in the phrase "justice for all." But it's an important critical work, worth reading for the author's re-examination of our country's policymaking approach. To succeed in breaking the cycle of poverty and closing the wealth gap, he suggests, we need to get back the fundamentals of democracy—developing policies and laws that apply to *all* Americans, not just those who can pay up front and in cash. ■



Online exclusive

When the majority of Americans see no improvement in their living standards, one macroeconomist asserts the outcome spills beyond singular households. In an interview with *Forefront*, Benjamin Friedman of Harvard University explains how sustained income stagnation leads to unfortunate tendencies in our society today. Hint: Dysfunctional governance is one of them.

www.clevelandfed.org/ff/Friedman

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