

Forefront

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

Three Trends Influencing the Region's Growth



Trends in energy prices, steelmaking, and auto production could determine the course for the 2016 regional economy.

INSIDE:
Return to Normalcy?
Protecting Small-
Business Borrowers
Raises and Rises

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Forefront
Federal Reserve Bank of Cleveland
PO Box 6387
Cleveland, OH 44101-1387
forefront@clev.frb.org
clevelandfed.org

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America's Bank: The Epic Struggle to Create the Federal Reserve

President and CEO: Loretta J. Mester

Editor: Amy Koehnen

Writer: Michelle Park Lazette

Managing Editor: Tasia Hane-Devore

Contributors:

Brett Barkley
Joel Elvery
LaVaughn Henry
Dan Littman
Maureen O'Connor
Robert Sadowski
Murat Tasci
Chris Vecchio
Guhan Venkatu
Christine Weiss
Ann Marie Wiersch

Mark Schweitzer, Senior Vice President, Outreach and Regional Analytics
Lisa Vidacs, Senior Vice President, Corporate Communications and Engagement

Design: Parente-Smith Design Inc.

Presidential Pulls

Loretta J. Mester, president and chief executive officer of the Federal Reserve Bank of Cleveland, has shared her expectations for the economy, labor markets, and more. For the full text of President Mester's speeches, visit www.clevelandfed.org, keyword "speeches."



INFLATION FIRING

"I am reasonably confident because when you look at the factors figuring into the inflation forecasts, inflation expectations have been reasonably stable. We have growth, above-trend growth. We have labor markets' improvement continuing."

—From an interview on Bloomberg TV, August 28, 2015

ECONOMIC RESILIENCY

"The resiliency of the economy through the episode in August, as well as the strength in final sales in the third quarter, suggests to me that there continues to be positive economic momentum. I anticipate that after the weak third quarter, growth will pick up over the rest of this year and next, to an above-trend pace in the 2.5 to 2.75 percent range."

—From a speech in Cleveland, Ohio, November 13, 2015

REACHING GOALS

"In my view, the totality of evidence suggests that the economy is at or very nearly at the Fed's mandated monetary policy goal of maximum employment, and with growth resuming at an above-trend pace, I expect to see further improvement."

—From a speech in Cleveland, Ohio, November 13, 2015

A GRADUAL RISE IN THE FED FUND RATE

"One benefit of the gradual approach is [that] it will allow us to recalibrate policy over time as some of the uncertainties surrounding the underlying economy in the post-crisis world, like the longer-run economic growth rate, are resolved."

—From a speech in New York, New York, October 15, 2015

A STRENGTHENING ECONOMY

"[T]he economy can handle an increase in the fed funds rate. A small increase in interest rates from zero is not tight monetary policy, and with the economic progress we've made and that I expect to continue, monetary policy can take a step back from the emergency measure of zero interest rates."

—From a speech in Columbus, Ohio, July 15, 2015

FOURTH DISTRICT OUTLOOK

"Overall, my forecast is that the Fourth District economy will continue to expand and labor markets will continue to improve. Household and business balance sheets have improved substantially over the expansion, and with the economy on firm footing, I expect that demand for business credit in the region will continue to rise."

—From an interview with the Pennsylvania Association of Community Bankers, September 15, 2015

THE FUTURE PATH OF POLICY

"When it comes to monetary policy, timing isn't everything. . . . More important for macroeconomic performance is the expected path of policy beyond liftoff because expectations about the future path of policy can affect today's economic decisions."

—From a speech in Columbus, Ohio, July 15, 2015

Latest Large Loan Review Finds Weaknesses

An examination by financial regulators finds lacking underwriting standards and high credit risk for credits that involve millions of dollars and multiple institutions.

When it comes to loans shared by 3 or more federally supervised financial institutions in aggregate amounts of \$20 million and more, credit risk remains high despite a relatively favorable economic environment, and there are pockets of weakness, financial regulators have found.

That's the word from the 2015 Shared National Credits review by the Federal Reserve Board, the Federal Deposit Insurance Corp., and the Office of the Comptroller of the Currency.

Even though the quality of shared national credits has improved following the financial crisis, regulators are still seeing higher levels of classified credits, or those rated substandard, doubtful, or loss, than they saw pre-crisis, explains John C. Shackelford, a senior examiner with the Federal Reserve Bank of Cleveland.

And that "higher low" level of classified loans actually increased slightly between the 2014 review and the most recent review because of leveraged loan weakness and because oil and gas credits are challenged in the present low-oil price environment.

The Shared National Credits (SNC) review tests a sample of commercial and industrial loans, allowing regulators to observe and assess banks' risk ratings. The most recent analyses were prepared in the

second quarter of 2015 and examined credits booked in recent years.

According to results released in early November, oil and gas and leveraged loans exhibit signs of weakness. The SNC examination noted weaknesses in underwriting standards in 28 percent of the loan transactions sampled, higher than experienced in recent years. The most frequently cited underwriting deficiencies were minimal or no loan covenants, liberal repayment terms, repayment dependent on refinancing, and inadequate collateral valuations.

Banks in the Cleveland Fed's region, which comprises Ohio, western Pennsylvania, the northern panhandle of West Virginia, and eastern Kentucky, have "a pretty modest exposure in oil and gas," according to Shackelford.

A number of banks in the Fourth Federal Reserve District do participate in shared national credits, he notes, and regulators expect them to do their due diligence.

"They have to rely on *their* underwriting," he explains. "They cannot, should not, rely only on the originating bank. They have to do their own due diligence and assessment and understand the risks involved."

The Shared National Credits review began in 1977. Just this year, the number of SNC examinations was increased from 1 to 2 annually. The next will take place in the spring. ■

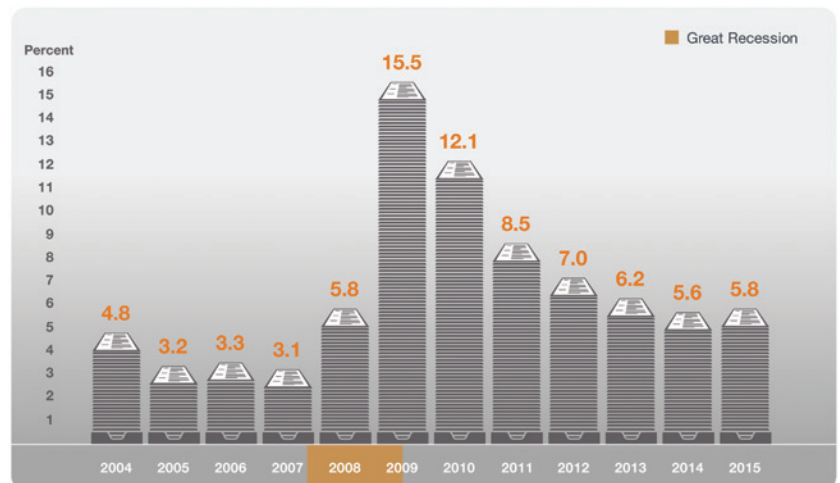
—Michelle Park Lazette

Read more



See the full 2015 Shared National Credits review: <http://tinyurl.com/pmtavs8>

The percentage of shared national credits commitments considered substandard, doubtful, or loss remains higher than pre-crisis levels.



Source: Shared National Credits Program 2015 Review.

Job Accessibility in Northeast Ohio

Lacking transit access, many lower-skilled workers miss out on jobs.

Mum's the word when it comes to job access in Northeast Ohio. A recent report by the Fund for Our Economic Future, an alliance of Northeast Ohio funders dedicated to advancing growth and opportunity, notes job access is the most important issue no one is talking about. Poor job accessibility can increase jobless rates and make it harder for families to move up the economic ladder. To get people talking, the Fund convened focus groups of representatives from the civic and nonprofit sectors across the region, including representatives from the Federal Reserve Bank of Cleveland.

From land-use decisions and business locations to per capita spending on transportation, it turns out regional leaders have much to say about job access.

While the Fund plans to continue to raise the level of awareness around this issue, one of our takeaways from the focus group was the need among local business leaders and policymakers for a better understanding of accessibility by job type and how accessibility varies across the Northeast Ohio region. This is the subject of a new study from the Cleveland Fed's Community Development staff titled "A Long Ride to Work: Job Access and Public Transportation in Northeast Ohio." It finds that

the largest share of Northeast Ohio's workforce—workers with only high school diplomas—experiences the lowest levels of job access. When job access is measured by a 90-minute-or-shorter transit ride, they are able to reach, on average, just 28 percent of jobs in the region, compared to workers with at least a bachelor's degree, who can access around 35 percent of jobs in the same transit commute time.

Moreover, access varies greatly by county. In most outlying counties, less than 10 percent of regional jobs can be accessed in 90 minutes or fewer.

Looking at the other side of the coin—what percent of the labor force is accessible to employers—the Cleveland Fed finds that half of Northeast Ohio's top 10 employment centers have access to only 15 percent or less of the regional workforce. Employment centers with the highest concentration of low-skill jobs tend to experience the lowest labor-force accessibility rates.

What can Northeast Ohio business and civic leaders do to increase job access?

One approach is to build on current strengths. Seven of the 8 counties included in the Cleveland Fed study provide relatively good public transportation service to county residents. But because each transit agency is county-based, limited services exist across jurisdictional lines.

Such an approach would also entail focused investment in the region's top job centers in terms of business location and transit connections. Viable opportunities for transit-oriented development such as along the Downtown–University Circle–Ohio City corridor should be leveraged in concert with strategies to preserve affordable housing as these areas potentially gentrify. However, more needs to be done to better connect large suburban employment centers, where most of the region's low-skill jobs exist.

Effective policy solutions will require engagement among public and private actors that influence economic development, transportation, housing, and workforce-development decisions. Let's keep the conversation going around job access: The region's economic competitiveness depends on it. ■

—**Brett Barkley**

Read more



Learn more about the Cleveland Fed's findings in "A Long Ride to Work: Job Access and Public Transportation in Northeast Ohio." Read it here: <http://tinyurl.com/pyfh7ss>.

Also, check out work from the Fund for Our Economic Future in "The Geography of Jobs: The Increasing Distance between Jobs and Workers in Northeast Ohio and Why It Matters for Future Growth." Find the PDF here: <http://tinyurl.com/nqq8ef9>.

Three Trends Influencing the Region's Growth

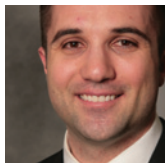
Trends in energy prices, steelmaking, and auto production could determine the course for the 2016 regional economy.



Mark Schweitzer
Senior Vice President



Robert Sadowski
Senior Economic Analyst



Christopher Vecchio
Senior Research Analyst

National economic growth continues at a moderate pace, but this growth hasn't prevented some nervousness about the outlook for the US economy. Notably, the stock market moved sharply lower in the third quarter of 2015, though it has subsequently recovered much of those losses. This decline in stocks, according to market commentators, was in large part due to concerns about geopolitical events and the softness in emerging-market economies. And these issues have continued to contribute to a volatile stock market in the early part of 2016.

Focusing on our region, which comprises Ohio, western Pennsylvania, the northern panhandle of West Virginia, and eastern Kentucky, the data show continued growth. However, we have noticed more nervousness about the outlook for growth among some of our regional contacts.

To supplement the District's economic data, we regularly collect qualitative assessments of the District economy from a wide range of contacts. Over the past year, those assessments have suggested a gradual weakening of the District's economic growth. At the start of 2015, our *Beige Book* summary of the region's economy noted ongoing "moderate growth," and most of our contacts had "a positive outlook for the new year." By the November *Beige Book*, however, our District's assessment of growth was lowered to "modest," with factory output being "stable" on balance.

While the reports we've been receiving from *Beige Book* and other business contacts are best interpreted as mixed, fundamentals (such as employment growth) for the broader District economy are good. So despite the weakening sentiment of District contacts' reports and the cautious tone of the stock market, we continue to expect growth across the District in coming months.

"While there are challenges to the District's economy, consumer spending is supporting continued growth." (p. 6)

Three important trends underlie our view of the District's pace of economic growth.

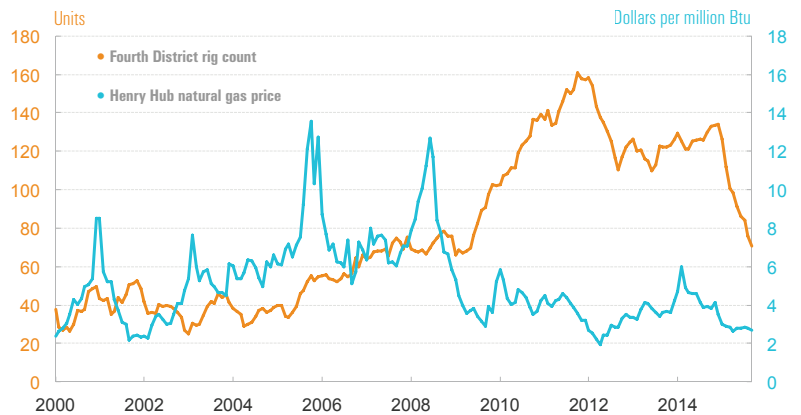
1 The fall in energy prices has caused a significant slowdown in oil and gas exploration in the Marcellus and Utica Shales, though natural gas production remains at historic highs.

Oil prices slid dramatically in late 2014 when worldwide demand for oil failed to keep up with rising supplies driven by renewed growth in US production. Domestic production has rebounded gradually over the past few years as drillers have brought resources to market with the combined technologies of hydraulic fracturing and extended reach drilling, or ERD.

Use of these technologies has been growing in the Fourth District, as well. Ohio and Pennsylvania experienced 25.7 percent and 12.8 percent rises, respectively, in oil and gas extraction employment between January 2013 and January 2015, mostly in the Marcellus and Utica Shale regions in western Pennsylvania and eastern Ohio. However, the number of active drilling rigs across the District began a rapid decline in February 2015 and has declined more than 50 percent during the entire year after peaking in mid-December of 2014. One evident point is that Fourth District drilling is sensitive to natural gas prices, and this sensitivity explains the slowdown in drilling activity in 2012. However, recent oil and natural gas price declines had an even larger impact on drilling activity this year. While low energy prices result in higher discretionary income for consumers and wider margins for energy-intensive industries, they also contribute to widespread layoffs by exploration and production companies.

Of course, direct employment is only part of the story in affected regions: Suppliers, restaurants, other service providers, and royalty-payment recipients have all experienced the slowdown. Helpful for continued District activity is that natural gas production within the District includes other components such as ethane, which is a building block of the plastics industry. More positively, anecdotal reports suggest ongoing investment, albeit at a modest pace, in midstream natural gas projects as well as the potential for construction of one or more ethane crackers. These midstream and downstream investments could potentially support ongoing growth in the energy sector despite today's low energy prices.

Fourth District drilling is sensitive to natural gas prices.



Source: Wall Street Journal/Haver Analytics, Baker Hughes.

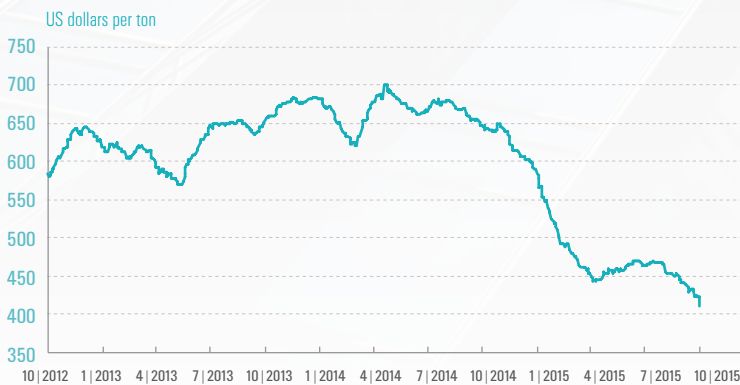


Every state in our District has at least twice the typical employment share of primary metals workers.

2 The rising value of the dollar and the weakness in oil and gas exploration have affected key District industries, including steelmaking. Steel producers are encountering difficulties even while domestic market users of District manufacturing products, namely construction and transportation equipment, are seeing growth.

Critical suppliers to the oil and gas industry—steel producers and steel service centers—have been affected by the slowing in exploration, but the larger issue has been the weakening in developing markets and the strength of the dollar. Foreign steel producers, benefiting from a drop in the value of their home currencies but also experiencing weak demand in their own countries, have put significant downward pressure on international prices of steel.

The decline in steel prices will likely impact the Fourth District's economic outlook.



Source: Wall Street Journal.

It's an important headwind in the region because steelmaking still maintains a significant presence across the District. Every state in our District has at least twice the typical employment share of primary metals workers, with Ohio's share sitting at 2.6 times larger than national figures.

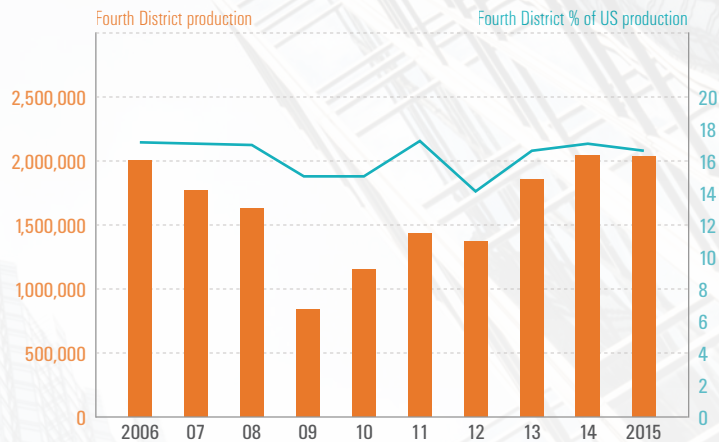
Steel production declined 11.5 percent nationally from the third quarter of 2014 to the third quarter of 2015, though it has slowly risen since October 2015. Although this decline is not as large as the decline during the Great Recession, when national production fell more than 50 percent, according to the Federal Reserve Board of Governors' industrial production data, steel industry contacts are not optimistic about today's environment or the near-term outlook. A lack of optimism will likely weigh on the District's economic outlook, but other consumers of steel such as the auto industry continue to perform at an elevated level.

3 Nationally and regionally, consumers are increasing purchases of durable goods, particularly automobiles, as their circumstances and balance sheets improve.

While there are challenges to the District's economy, national consumer spending is supporting continued growth in both the nation



The recent surge in automobile sales has bolstered District production.



Source: WardsAuto.com.

Note: Production period is for the model year. The 2015 model year runs from October 1, 2014, through September 30, 2015. Production includes cars, light trucks (SUVs and light-duty trucks), and medium-duty trucks.



and the region. Regionally, this situation is most evident in one of the District's key industries: automobile production.

In recent months, automobiles have been selling in the United States at a rate of more than 18 million per year. This is an extraordinary figure, and it means that District auto production has returned to more than 2 million cars per year. District auto plants over the last several years have produced about 17 percent of the nation's cars and light trucks—and they still do despite the 2008 closure of Moraine Assembly, an SUV plant in Dayton, Ohio. That plant produced 212,000 Chevy Trailblazers and other SUVs in the 2007 model year. District auto contacts expect that the pace of growth in unit sales will level out in the near-term, but they remain optimistic in their outlook.

District auto production has returned to more than 2 million cars per year.

The Fourth District is experiencing some headwinds weighing on the regional outlook, but these are tempered by some favorable trends. Pulling disparate trends together shows a mixed economic outlook for the District, but one still consistent with continued growth, albeit at a moderate pace. Meeting the needs of domestic consumers represents almost 70 percent of US output, so with an improved labor market and with household balance sheets in better condition, most national forecasters are expecting steady growth in consumption. This powerful factor supports the national outlook, and it should similarly support District growth. ■

SUM AND SUBSTANCE

The Fourth District economy continues to expand, but it's facing some persistent headwinds.

2015

Year in Review:

Fourth District Labor Markets

The outset of a new year signals a look to the future, but it's also cause for reflection on the year that's drawn to a close.

The Cleveland Fed's Fourth District, which includes Ohio, western Pennsylvania, the northern panhandle of West Virginia, and eastern Kentucky, experienced some employment progress in 2015, but just how much? Here, we explore the District's employment situation over the past year by examining the performances of six major metropolitan statistical areas in the region—Cleveland, Cincinnati, Columbus, Lexington, Pittsburgh, and Toledo.



Joel Elvery
Economist



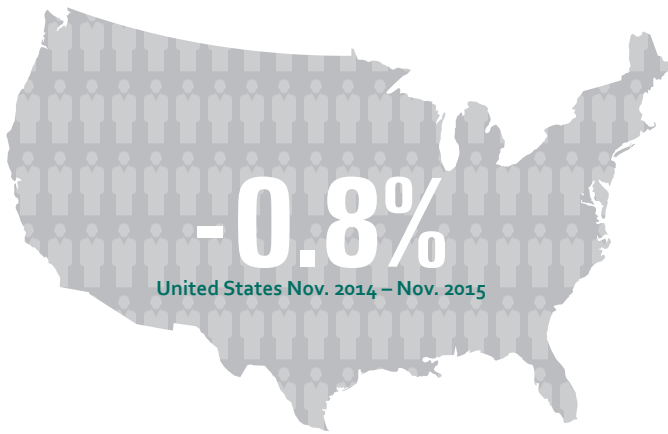
Maureen O'Connor
Staff Writer



Christopher Vecchio
Senior Research Analyst

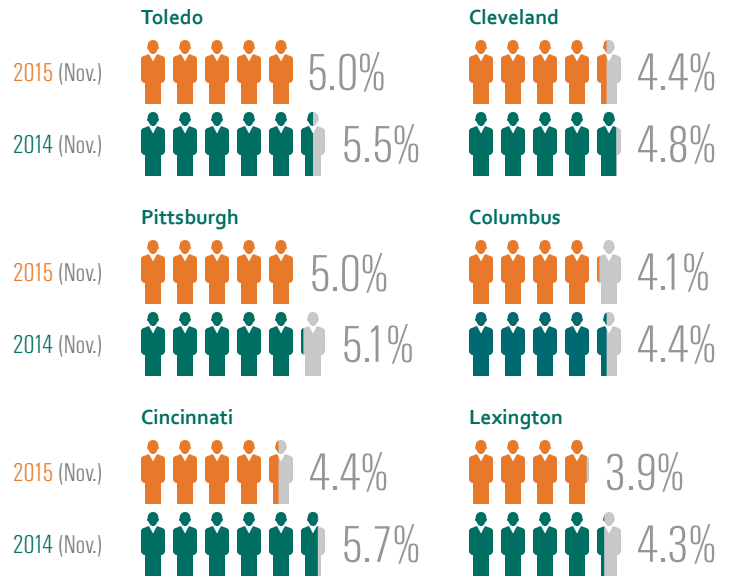
For the most part, unemployment rates dropped and employment levels increased across the District. As of November 2015, all 6 metro areas had unemployment rates at or below the national rate. Pittsburgh's unemployment rate was essentially flat from 2014 to 2015, while its regional counterparts all experienced declines ranging from 0.3 percentage points (Columbus) to 1.3 percentage points (Cleveland).

Unemployment Rates



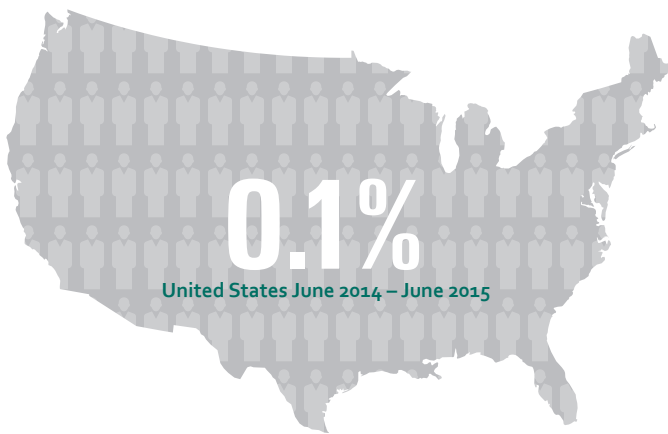
Note: Data are seasonally adjusted.

Source: Bureau of Labor Statistics' Current Population Survey and Local Area Unemployment Statistics program.



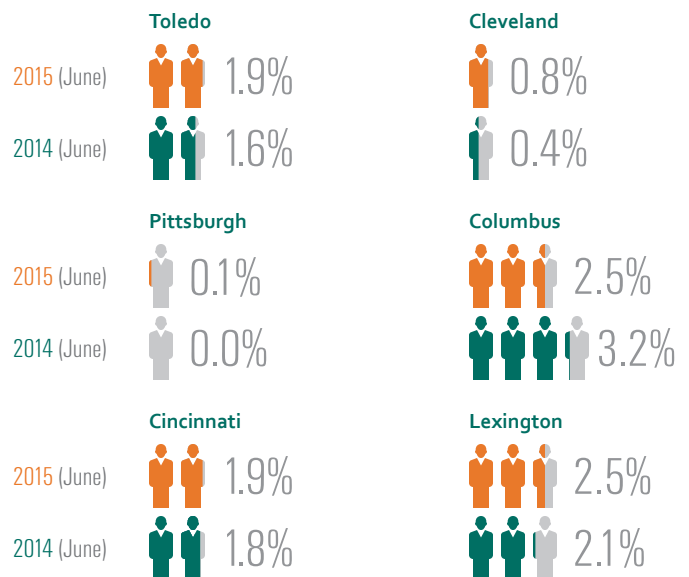
Still, Pittsburgh recovered its pre-recession employment level by 2012, much earlier and quicker than most major metropolitan statistical areas (MSAs) or the nation. This to some degree accounts for its stable unemployment rate and employment over the past year. On the employment side, the MSAs all experienced more growth in 2015 with the exception of Lexington. While that region still posted gains in 2015, employment grew more quickly in 2014. Note that these employment data come from the Quarterly Census of Employment and Wages, which is less timely than other sources but significantly more accurate.

Year-Over-Year Total Employment Growth Rate



Note: Data are seasonally adjusted.

Source: Bureau of Labor Statistics' Quarterly Census of Employment and Wages, December 2, 2015.



Does drilling further into sectoral employment indicate dissimilarity between the employment performance of these MSAs and the nation? In some cases, yes. From 2014 to 2015, the nation gained a bit of employment in the information sector. At the metro level, all 6 MSAs experienced fairly severe declines with the exception of Cincinnati, where information employment was flat. For natural resources and mining, the nation's employment declined by 3 percent while several MSAs experienced gains. And in both Columbus and Lexington, 6 major sectors gained more employment than did the nation. The tables below catalog year-over-year employment changes by sector at the metro and national levels.

Year-Over-Year Percentage Change in Employment June 2014 – June 2015

	Cincinnati	Cleveland	Columbus	Lexington	Pittsburgh	Toledo	United States
Total employment (seasonally adjusted)	1.9	0.8	2.5	2.4	0.1	1.8	2.0
Construction	4.5	1.1	3.5	10.2	0.0	6.6	4.7
Leisure and hospitality	3.3	1.8	2.4	6.4	0.7	1.7	2.8
Professional and business services	0.9	0.1	1.8	2.3	1.8	3.5	2.6
Education and health services	1.3	1.1	3.9	5.5	-0.5	-1.5	2.4
Trade, transportation, and utilities	2.2	0.9	2.9	2.1	-0.1	2.6	2.2
Financial activities	2.2	1.2	3.9	3.1	-0.7	2.0	1.9
Manufacturing	3.0	0.7	2.9	1.3	-0.3	2.7	1.2
Government	0.5	0.2	1.2	-0.7	-0.7	2.0	0.6
Information	0.0	-4.1	-4.9	-5.8	-1.1	-7.3	0.6
Natural resources and mining	1.4	0.4	8.1	-0.4	-2.6	2.6	-3.0

■ Greater than 3.0
■ 2.0 to 3.0
■ 1.0 to 2.0
■ -1.0 to 1.0
■ -2.0 to -1.0
■ -3.0 to -2.0
■ Greater than -3.0

Note: Some missing values for Cincinnati and Cleveland were imputed.

Source: Bureau of Labor Statistics' Quarterly Census of Employment and Wages, December 2, 2015.

Year-Over-Year Percentage Change in Employment Level June 2014 – June 2015

	Cincinnati	Cleveland	Columbus	Lexington	Pittsburgh	Toledo	United States
Total employment (seasonally adjusted)	19,185	7,593	23,931	6,161	1,417	5,160	2,820,218
Construction	1,806	408	1,168	1,062	-5	811	297,723
Leisure and hospitality	3,914	1,866	2,470	1,789	815	556	424,762
Professional and business services	1,398	169	2,926	810	2,957	1,165	501,116
Education and health services	1,990	2,106	5,485	1,625	-1,084	-714	495,798
Trade, transportation, and utilities	4,222	1,665	5,341	976	-168	1,417	579,634
Financial activities	1,322	702	2,667	279	-474	183	149,954
Manufacturing	3,266	850	1,993	397	-245	1,172	143,597
Government	567	224	1,714	-312	-797	743	137,439
Information	0	-586	-839	-317	-188	-224	15,625
Natural resources and mining	19	14	263	-20	-313	33	-65,399

Note: Some missing values for Cincinnati and Cleveland were imputed.

Source: Bureau of Labor Statistics' Quarterly Census of Employment and Wages, December 2, 2015.

Each MSA has a set of sectors in which it specializes. The employment concentration of these sectors is substantially higher in the metro areas than at the national level. Based on this aggregate relationship, the sectors with a higher concentration of employment are considered major drivers of the local economy. The table below shows the 2 most concentrated sectors for each MSA. For the most part, the activity in these sectors had a meaningful impact on the overall employment performance in their respective MSAs. The only outlier, Lexington. The metro area's positive employment performance from 2014 to 2015 was driven by other sectors.

Top 2 Most Concentrated Employment Sectors Per Fourth District MSA

MSA	Sectors	Share of Employment	Employment Level
Cincinnati	Manufacturing	11.2	113,666
	Professional and business services	15.7	159,226
Cleveland	Manufacturing	12.4	125,367
	Education and health services	18.6	188,662
Columbus	Financial activities	7.2	70,757
	Professional and business services	17.1	168,442
Lexington	Manufacturing	11.8	30,780
	Natural resources and mining	1.8	4,740
Pittsburgh	Education and health services	20.1	224,541
	Financial activities	6.1	68,134
Toledo	Manufacturing	15.2	44,055
	Education and health services	16.7	48,514

Note: Most concentrated sector is listed first.

Source: Bureau of Labor Statistics' Quarterly Census of Employment and Wages, December 2, 2015.

To sum it all up:

- Columbus and Lexington performed at the national level or better in terms of employment gains in 2015
- Cincinnati and Toledo were just below the national trend
- Cleveland posted smaller gains
- Pittsburgh had limited employment gains

In other words, 2015 wasn't a banner year for employment gains in these MSAs, though there was moderate growth. All 6 of these metro areas had lower unemployment rates than did the nation, and this means their employment growth was large enough to absorb many available workers.

Read more



The Cleveland Fed's Fourth Federal Reserve District is profiled in *Metro Mix*, our publication providing snapshots of economic conditions and prospects for the 6 MSAs featured here. For more information on their economies, including data and analyses, [visit clevelandfed.org/MetroMix](http://visit.clevelandfed.org/MetroMix).

Raises and Rises

As a poverty-reduction tool, raising the minimum wage isn't without drawbacks.

As policymakers and economists across the country debate the merits and pitfalls of an increase, the federal minimum wage sits at \$7.25 per hour for non-tipped workers and \$2.13 for tipped workers. Ohio and West Virginia, two states within the Federal Reserve Bank of Cleveland's Fourth District, which comprises Ohio, western Pennsylvania, the northern panhandle of West Virginia, and eastern Kentucky, have state minimum wages that exceed the federal minimum. Two others in the District, Pennsylvania and Kentucky, match it. As pressures to raise wages escalate across the nation, some major metropolitan areas such as San Francisco and Washington DC are taking matters into their own hands and effecting area-wide raises—for better or worse. Large companies, too, many in food service and retail industries, are feeling the pressure as calls come in from multiple corners to raise wages for their lowest-paid workers.

We wanted to know, to what extent might a rise in the minimum wage affect hiring and employment, and who would feel the pinch? We sat down with Murat Tasci, senior research economist at the Cleveland Fed, and asked him some tough questions.

“It’s not clear how an increase would unambiguously help with a poor household’s problem.” (p. 15)



Murat Tasci
Economist

Forefront: *The federal minimum wage was last raised in 2009. What drives the current push for an increase?*

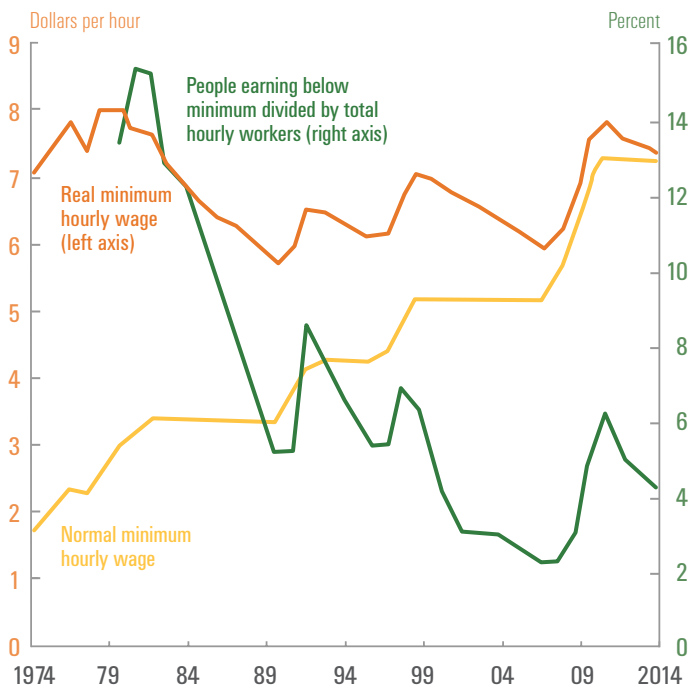
Tasci: Since the US federal minimum wage is set nominally, over time it tends to decline in terms of its purchasing power. Changes since the 1980s coincide with a decline in the real hourly minimum wage to around \$6 per hour (normalized to 2015 levels). This time around, though, in real terms the minimum wage doesn’t seem to be exceptionally low relative to its high levels in the late 1970s. It’s hard to speculate, but I’m presuming the stagnant median household income over the past two decades has something to do with it. In 2007, median

household income was \$57,357, but fell substantially during the Great Recession. The most recent data for 2014 indicate that real median household income recovered, but only to \$53,657.

Forefront: *One aspect of the current debate about raising the federal minimum wage is that doing so may cost jobs and increase unemployment. What are your thoughts?*

Tasci: Evidence points to disemployment effects, meaning that a minimum wage increase reduces employment for the groups of workers in the intended population. The argument for raising the minimum wage is often not about the effects on employment numbers. Instead, the intention is

Real minimum hourly wages are not substantially low relative to the high levels of the 1970s.



Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, Haver Analytics.

to provide a higher living standard for lower-skilled workers. But if the additional labor cost incurred from a higher minimum wage leads employers to cut jobs, the policy will produce a substantial unintended consequence. While the estimated effects are small, much of the evidence suggests that the negative effects on employment in response to raising the minimum

wage fall disproportionately on low-skilled workers. An important note to the existing research is that it has largely relied on small changes in the minimum wage to identify effects. Many of the current proposals would be for larger changes, potentially making the employment effects estimates unreliable.

If the additional labor cost incurred from a higher minimum wage leads employers to cut jobs, the policy will produce a substantial unintended consequence.

Forefront: *What benefits and pitfalls are there to raising the minimum wage piecemeal by city or state rather than federally?*

Tasci: One obvious benefit is the cost of living might be different by location. So if the motivation is to raise the living standard of lower-wage earners, the right benchmark should be different in New York City than in, say, Youngstown, Ohio. On the other hand, if the locations are physically close, firms might relocate to avoid facing a minimum wage hike in one location, thereby shifting employment to another location without worker benefit.

Forefront: *What effects would increasing the minimum wage have on employment, particularly in the current labor market in which large corporations have generally recovered from the recession but smaller businesses might still be struggling?*

Tasci: An increase poses another challenge for the strength of the recovery. Not only is the labor market recovering from one of the deepest recessions in US history, but it also faces intensifying challenges from technological

Small businesses will be especially affected because they often lack other instruments to absorb cost increases.

changes. Lower-skilled workers performing routine tasks are increasingly replaced with machines and software, thereby reducing demand for human labor. Assuming we'll face similar results in line with empirical evidence, a substantial increase will reduce job creation. How much will depend on the magnitude of the change. Small businesses will be especially affected because they often lack other instruments to absorb cost increases.

Forefront: *What effects would increasing the minimum wage have on family income?*

Tasci: It depends on who we're talking about. Undoubtedly, there are single parents who earn minimum wage working one or more part-time jobs, and most arguments in favor of an increase emphasize the positive income effects on such households. But minimum wage is not a function of household income, so it follows that raising it doesn't necessarily target this type of household. Really, many

of the people likely to benefit from an increase are teenage members of wealthier households. In the end, then, it's not clear how an increase would unambiguously help with a poor household's problem, especially if it increases the likelihood of losing a job. As a poverty-reduction tool, minimum wage is a very blunt one, and research suggests that its negative employment effects are amplified for exactly the groups needing targeted poverty measures.

Forefront: *Is there a course of action that could help mitigate any unintended consequences of a federal minimum wage hike?*

Tasci: When minimum wage has negative effects, it's because it induces distortion into the marketplace. A society can decide whether it prefers to induce this distortion and raise incomes for a group of low-wage earners in spite of the risk of increasing the number of unemployed from the same group. But it might make more sense to devise a targeted poverty-reduction measure for the low-income households directly,

such as with the Earned Income Tax Credit. This particular credit depends on household income, so it would benefit the single parent in the previous example. As long as the parent's total income meets certain thresholds, his or her tax burden will be substantially alleviated, effectively raising the household's income.

Forefront: *What's presently on the minds of those who study minimum wage and unemployment, something that may be obscure but significant?*

Tasci: I think to understand the effects of the minimum wage, one must be aware of the characteristics of most minimum-wage earners. Plus, the fraction of workers who earn at or below the minimum wage is quite close to its lowest levels, around 3.9 percent of hourly paid workers in 2014, down from 15.1 percent in 1980. This substantial decline cannot be attributed to the changes in the real minimum wage, suggesting that the market for minimum wage jobs is probably disappearing. ■

—Tasia Hane-Devore

SUM AND SUBSTANCE
Raising the minimum wage won't necessarily reduce poverty.

Read more



Want to know more about minimum wage effects? See "Positive and Normative Effects of a Minimum Wage" for more information: <http://ow.ly/UOo0V>

Return to



"One thing you've got to look at is the business cycle. There's always a high, and there's always a low." (p. 19)

Normalcy?

The levels of bank reserves for covering loan losses are nearly back to pre-crisis levels. That may mean the industry is out from under the overhang of bad debts that's plagued it, but the question remains: **Would the reserves be enough if crisis strikes anew?**



Michelle Park Lazette
Staff Writer

"It's hard to argue, 6 years out from the financial crisis, that we're far enough out from it that our memories have completely disgorged the fact that really bad things can happen." (p. 20)

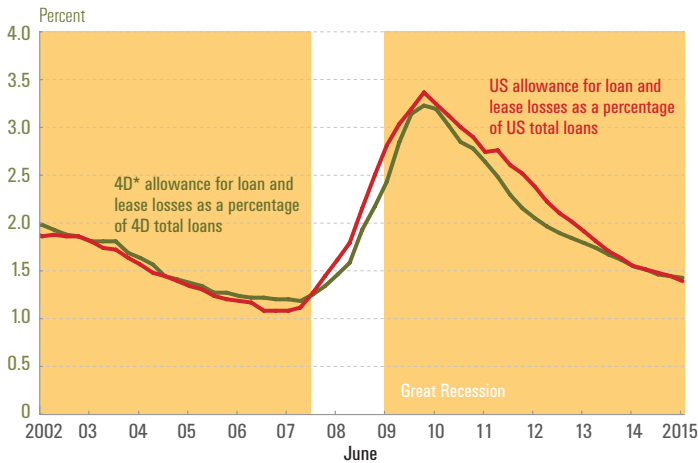
Nearly 8 years after the 2008 banking crisis began, the cushion of income banks set aside to cover losses is nearing pre-crisis levels.

Technically, the income cushion reserved for loan losses is referred to as the ALLL, the industry's allowance for loan and lease losses, or "loss reserves" for short. It is a reserve account set aside to absorb expected losses—such as those that banks incur when borrowers don't repay loans or when investments fail.

Years before late 2007, when the recession officially began, the ALLL as a percentage of total bank loans was either dropping slightly or stable among institutions in the United States and in the Fourth Federal Reserve District, the region the Cleveland Fed serves. Then came the tremendous spike when banks' bad debts ballooned, requiring banks to funnel funds into loss reserves. ALLL to total loans more than doubled between late 2007 and early 2010, when the loan losses peaked.

Since the end of the first quarter of 2010, however, the industry's loss-reserves-to-total-loans percentage has been steadily dropping, and in recent quarters the percentage has flirted with pre-crisis levels.

Loss-reserves-to-total-loans ratios more than doubled in recent years, but now are near pre-crisis levels.



*4D: The Fourth Federal Reserve District comprises the state of Ohio, western Pennsylvania, the northern panhandle of West Virginia, and eastern Kentucky.
Source: Bank call reports.

Banks that are no longer shoveling earnings into their reserves likely have more retained earnings for accumulating capital and paying shareholder dividends, says John C. Shackelford, a senior examiner with the Federal Reserve Bank of Cleveland.

“And,” he adds, “you would hope to see more credit availability.” Read: more lending.

James Thomson sees the return of loan loss reserves to pre-crisis levels as a signal that perhaps the banking industry is back to normal, that a lot of the bad credits bankers have been holding reserves against are “finally cured.”

“If we’ve returned to normalcy, maybe we’ll start to see lending come back,” says Thomson, professor and chair of finance at the University of Akron and former vice president and financial economist at the Cleveland Fed. “Having bad loans on your books is a huge distraction. You have to manage them. You have to try to collect them. Maybe this is a first step toward lending starting to come back.”

Banking supervisors with the Federal Reserve Bank of Cleveland don’t see the shrinking loss reserves as cause for concern.

For one, the ratio of the ALLL to total loans has gradually returned to pre-crisis levels and hasn’t dipped below what it was before the downturn, says Jason E. Tarnowski, an assistant vice president at the Cleveland Fed.

“Even with some loan growth, the ratio of reserves to those loans has kept pace,” he explains.

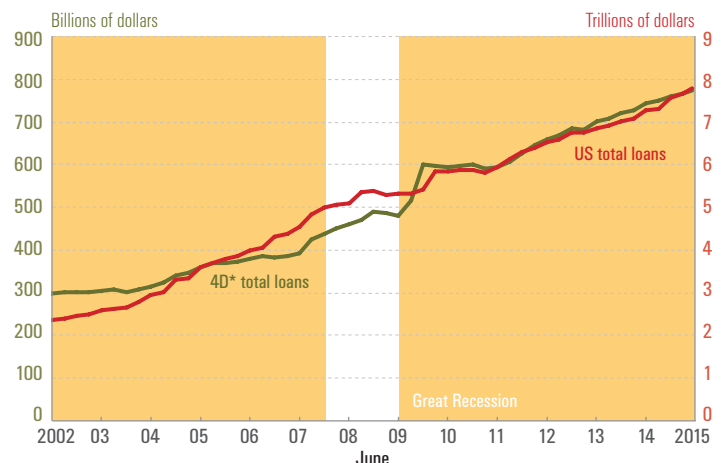
Still, a question lingers: If, as the industry learned the hard way, the pre-crisis levels of loss reserves did not suffice in this most recent crisis, what’s to say the same percentages today would suffice if another downturn strikes?

Downward trends

Of course, the loss reserves are not the only earnings banks may use to absorb losses, Cleveland Fed supervisors note. A bank’s equity, or capital, is inherently loss reserves. It’s often said that the loan loss allowance is for *expected* losses, and a bank’s equity is a cushion for the unexpected. That latter cushion is, by design, *not* returning to what it was pre-crisis.

“The difference between today and pre-crisis is banks have much more capital than they had pre-crisis,” Shackelford says, crediting actions taken by the regulatory agencies. “They have much better metrics at the portfolio level and the individual-loan level. There are better monitoring systems. We put [the largest banks] through the CCAR [Comprehensive

Since the Great Recession’s end, bank lending has grown 61% in the Cleveland Fed’s region and 47% in the US.



*4D: The Fourth Federal Reserve District comprises the state of Ohio, western Pennsylvania, the northern panhandle of West Virginia, and eastern Kentucky.
Source: Bank call reports.

Capital Analysis and Review] exercise once a year where they have to forecast what their losses would be in hypothetical adverse scenarios. That helps forecast how their loans might perform.”

In speaking to why lower loss reserves aren't necessarily out of turn, Cleveland Fed supervisors also note that the metrics that reflect bad debts—90-days-past-due debts; non-accruing debts, or those for which repayment of interest and principal is uncertain; and net charge-offs—are all headed in the same direction: down. Where bankers have fewer bad debts, bankers need less cushion.

“If your performance metrics are showing improvement, most likely your allowance and your provisions are declining,” says Rich Gallagher, a Cleveland Fed senior bank examiner. “One thing you’ve got to look at is the business cycle. There’s always a high, and there’s always a low. The allowance kind of follows the business cycle. As things are improved, the allowance comes down.”

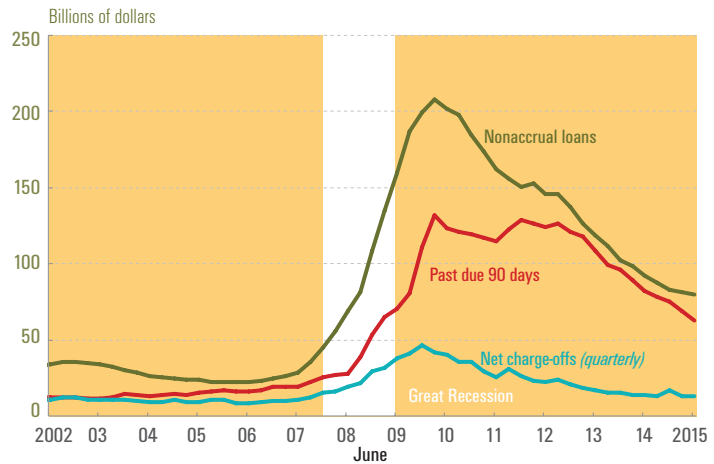
This return of loss reserves to pre-crisis levels is occurring at a time when some bankers are taking more risks and reducing underwriting standards such as loan covenants and increasing leverage limits to achieve yield in today’s low interest rate environment.

Bankers themselves report they are easing their standards.

The Federal Reserve’s July 2015 Senior Loan Officer Opinion Survey on Bank Lending Practices asked respondents from more than 70 banks to consider the range over which their lending standards have varied since 2005 and to report where their standards were relative to the midpoint of that range.

Domestic and foreign banks generally reported that lending standards are easing on some commercial and industrial loans products for large and middle-market firms. The survey found, too, that the lending standards for smaller firms have been gradually loosening over the past few years and that there’s been a gradual easing of lending standards, as well, for all 3 types of commercial

The volume of US banks’ problem assets has decreased in recent years.



real estate loans: construction and land development loans, loans secured by multifamily residential properties such as apartment buildings, and loans secured by nonfarm nonresidential properties such as office buildings.

‘An imprecise science’

What drives any institution’s loss reserves is the credit risk by loan product each institution identifies, explains the Cleveland Fed’s Gallagher. For example, similarly sized banks may have different loss-reserves-to-total-loans ratios because one may concentrate in secured real estate lending while another may book a significant volume of unsecured commercial and industrial loans.

Industry observers say it’s hard to know definitively whether the loss reserves at their current levels are enough.

“The adequacy of the loss reserve depends on the quality of the loan portfolio,” says Thomson of the University of Akron. “Historically, when the system’s not under a lot of stress, when we’re not in a severe economic downturn, a loss reserve of 1.5 percent is probably more than adequate.”

Nationwide, the allowance for loan and lease losses as a percentage of total loans stood at 1.40 percent as of

“The allowance kind of follows the business cycle. As things are improved, the allowance comes down.”

It's hard to know definitively whether the loss reserves at their current levels are enough.

June 30, per bank call report data. In the Cleveland Fed's region, which comprises Ohio, western Pennsylvania, the northern panhandle of West Virginia, and eastern Kentucky, the same metric was 1.43 percent.

"Obviously, we won't know" until we know, Thomson concedes. "But, if we have any faith in our ability to simulate stresses on the portfolios and get a reasonable picture under likely and adverse scenarios, I would guess there's nothing right now to suggest these reserves are inadequate."

But, Thomson acknowledges, if he'd told bankers in 2005 that their loan loss allowances were inadequate, "you would have rolled your eyes" based on what the reserves were relative to historic levels and relative to charge-offs, or the assets banks write off as losses. Yet as the recent past demonstrated painfully well, those pre-crisis loss-allowance levels didn't prove adequate for the mountainous losses banks would suffer.

"The thing that we have to be careful of is that all of this can be misleading," Thomson explains. "You can miss some stuff if there has been a discreet change in quality or . . . some major economic downturn. Then, stuff that looks adequate based on the recent past doesn't look adequate at all."

That said, Thomson notes, "It's hard to argue, 6 years out from the financial crisis, that we're far enough out from it that our memories have completely disorged the fact that really bad things can happen."

While it is the institutions' responsibility to monitor their loan portfolios, banking supervisors spend a lot of time monitoring institutions' risk-management practices, Tarnowski and Shackelford explain.

"We have discussions with the chief risk officers, the credit teams, and the loan officers to really determine what new products or services they are getting into and how they're approaching markets from an underwriting and interest rate perspective," Tarnowski says.

"It's an imprecise science," Shackelford adds. "There's a lot to it to try to get it right. We focus on the risk-management practices and look at how [banks] assess their risk and how accurate they have been over a period of time."

Beyond bank balance sheets and underwriting, there's a strengthening macroeconomy to consider when assessing the appropriateness of loss reserves, Tarnowski and Shackelford say.

"Financial institutions are greatly affected by the environment," Shackelford explains. "If house prices are improving, that's helping your consumers that have equity. And when your businesses are having stronger sales and earning money, it's easier for them to repay their loans."

While some macroeconomic conditions (among them improved unemployment and gross domestic product figures) tell a story of growth, there are pockets of stress such as low oil and steel prices that can affect bank portfolios negatively, Shackelford notes.

If banks are assessing their risks accurately, lower loss reserves should represent better credit quality in bank portfolios, Tarnowski says.

Also, the return to pre-crisis levels of loss reserves may indicate that banks' provision expense, or the reduction in earnings they incur when they add to their loss reserves, is not going to be as high going forward, Shackelford says.

Big change looms

Some banking supervisors would argue, Thomson notes, that banks were under-reserving in the years prior to the crisis.

There's a balance they must strike: Banks are regulated by bodies such as the Federal Reserve, the Office of the Comptroller of the Currency, and the Federal

Deposit Insurance Corp., yes. But those institutions that issue securities such as stock also are under the thumb of securities regulators such as the US Securities and Exchange Commission (SEC).

Whereas banking supervisors might want banks to hold more in loss reserves as a course of business, the SEC and the Financial Accounting Standards Board (FASB) don't want banks holding too much in their reserves to the extent that they misrepresent their earnings to investors. If banks provision more money to their reserves, they reduce reported earnings and, consequently, shareholders' equity.

There's potential big change on the horizon. Presently, bankers are to assess incurred losses and set up loss reserves accordingly, explains Bill Brewer, audit partner with Crowe Horwath LLP in Cleveland, whose financial services practice performs internal and external audit and consulting work for financial institutions.

Following the financial crisis, there was concern that accounting standards didn't allow companies to recognize losses via their loss reserves soon enough, notes Greg McClure, also an audit partner with Crowe Horwath.

"The timing of when provisions are recognized has been a concern for as long as I've been in the banking industry, which has been 30 years," McClure says. "What happened was the financial crisis just accelerated the pressure for the Financial Accounting Standards Board to look at the issue again."

In December 2012, FASB issued for public comment its proposal to change financial reporting about expected credit losses on loans and other financial assets in what it called the CECL model, or Current Expected Credit Loss impairment model. Under it, FASB aims to require "life of loan" estimates of losses on loans and debt securities. Said another way, CECL proposes that bankers project and recognize *expected* losses over the life of a loan rather than provisioning based on actual losses incurred over a period of time.

Beyond bank balance sheets and underwriting, there's a strengthening macroeconomy to consider when assessing the appropriateness of loss reserves.

Similar changes to accounting standards have been introduced in other parts of the world.

"It will be a meaningful challenge to forecast what could happen in the economy over the term of a loan," Brewer notes. "The ALLL estimate requires lots of judgments, and this [change] introduces additional elements of judgment."

Most observers, he says, expect this change—which isn't to take effect until 2018—to have a meaningful financial statement impact because they anticipate it will result in higher loss reserves.

"Hopefully the intended outcome proposed under CECL provides the necessary cushion for financial institutions to absorb future economic shocks to the loan portfolio and minimize the impact to financial stability within the United States," the Cleveland Fed's Tarnowski says.

The American Bankers Association asserts in an analysis on its website that the "life of loan" loss concept "will present significant problems to bankers," among them, requiring wholesale changes to ALLL estimation systems and also straining the capital of banks that offer long-term products because "losses that are possible several years in the future will be recorded, while the interest earned in the meantime is not." ■

SUM AND SUBSTANCE

As banks set aside less money in loan loss reserves, lending may increase, all while examiners remain focused on risk management practices and their accuracy.



Read more

The proposed change to the way banks provision money to their loss reserves is explained in a recent *Economic Trends* piece by Cleveland Fed researchers: <http://tinyurl.com/zpzy6lg>



Protecting Small-Business Borrowers

As alternative financing for small businesses grows, so does the debate over regulation.




Christine Weiss
Vice President, Legal



Ann Marie Wiersch
Senior Policy Analyst

Under the law, commercial-credit borrowers are viewed differently from consumer borrowers. Business borrowers, deemed more financially savvy than the average consumer, are not protected under the majority of consumer protection laws. For instance, credit extended primarily for business purposes is not covered by the disclosure requirements of the Truth in Lending Act.

Lenders thus have a great deal of flexibility with respect to the information they provide borrowers and the way they disclose a product's costs and features. As a result, borrowers have reported confusion in understanding the differences among various credit products and their costs, as noted in a Federal Reserve Bank of Cleveland report titled "Alternative Lending through the Eyes of 'Mom & Pop' Small Business Owners: Findings from Online Focus Groups." In practice, some borrowers have found themselves in high-cost products with terms and conditions they did not understand or interest rates that were not affordable for their small businesses.



“The newness of the industry and the lack of regulatory structure have given rise to questions about what, if any, intervention is needed and what supervisory authority agencies might have over small-business credit providers.”
(p. 25)

The Debate

Small-business advocates have called for disclosure rules that require lenders to describe their product terms and costs in clear and transparent language. They have also encouraged curbs on subprime lending and predatory practices that include stacking, namely, the practice of providing a merchant cash advance (MCA), a form of short-term funding, to a borrower who has an outstanding advance from another lender.

On the other hand, some industry proponents argue that regulatory intervention could stifle innovation and limit credit access for small-business customers who need financing to thrive. These observers assert that existing laws and regulations are sufficient to ensure that the market functions safely. (The accompanying table on page 20 sets forth a non-inclusive list of applicable regulations.) They support industry efforts to self-regulate and have urged policy makers to allow market discipline to weed out the so-called “bad actors” that engage in high-cost or predatory lending.

Much of the debate about borrower protections centers on online alternative-finance companies that provide MCAs to small businesses. These products have a reputation for being expensive and are often marketed to borrowers with FICO scores in the low 500s. Furthermore, to grow their customer bases, some MCA providers rely on new business generated by brokers that have been a source of concern about misleading and unethical practices.

The Alternative Finance Industry

Online alternative lending is one of several segments that comprise the “fintech,” or financial technology, sector. New fintech entrants are using technology to serve the financial needs of businesses and consumers, bringing innovative solutions to payments, lending, and other financial services. These companies, many of them startups, boast double- or triple-digit annual growth rates supported by considerable venture capital investment.

Specific to small-business services, estimates suggest that at least 150 alternative-finance companies in the US alone focus on extending credit to small firms. These nonbank credit providers operate online and offer a variety of products such as loans and cash advances, as well as hybrid products that carry features of both. Marketplace-lending platforms, also known as peer-to-peer lenders, are among the largest and most well-known. Other lenders competing for small-business borrowers include MCA providers, direct lenders who keep loans on their balance sheets, and payment processors that lend to their business-account holders. These lenders appeal to business owners seeking alternatives to banks for a number of reasons including 1) the owner’s inability to qualify or belief that he or she will not be approved for traditional bank financing; 2) the faster, simpler application process; 3) the easier lending standards; and 4) the potential to obtain funding more quickly.

About Merchant Cash Advances

An MCA is a form of short-term funding typically offered to small-business borrowers who primarily accept credit card payments, for example, retail businesses or restaurants. An MCA is different from a traditional loan in that the small business, in essence, sells a portion of its future receivables: cash up front in exchange for a percentage of future sales. Unlike a traditional loan, an MCA has no fixed term on the repayment of the advance, no minimum monthly payment, and, generally, no collateral or personal guaranty required. The cost

is based on the “factor rate” applied to the advance, a rate which typically ranges from 1.2 to 1.4.

Here’s what happens in a typical MCA arrangement: The borrower agrees to repay the lump-sum cash advance by allowing the MCA provider to take a fixed percentage of the borrower’s daily revenue until the advance and associated fees are repaid. To pay back the loan, the borrower then authorizes the MCA provider to withdraw that fixed percentage of sales from the borrower’s merchant account through which credit and debit card receipts are processed. To determine the

Relevant Legislation

Regulation B of the Equal Credit Opportunity Act (ECOA)

This regulation prohibits discrimination in any aspect of a credit transaction, whether for consumer or business purposes, on the basis of

- Race, color, religion, national origin, sex, marital status, or age (provided the applicant has the ability to enter into a contract)
- Receipt of public assistance
- The fact that the applicant has exercised any right under the consumer credit protection act

It also requires a creditor to notify the applicant of its decision within 30 days from receipt of a completed application.

Fair Credit Reporting Act (FCRA)

The FCRA stipulates that a creditor must notify a borrower if a personal consumer credit report is pulled in connection with a commercial transaction and an adverse action is taken based on that report.

Such “adverse action” includes a denial of credit, a modification of the requested terms, or a change in terms on an existing account.

Section 5 of the Federal Trade Commission Act (FTC Act)

Section 5 prohibits unfair or deceptive acts or practices in or affecting commerce and applies to both consumer and commercial transactions.

Such acts or practices include

- Making misleading cost or price claims
- Using bait-and-switch techniques
- Offering to provide a product or service that is not available
- Omitting material limitations or conditions from an offer
- Selling a product unfit for the purposes for which it is sold
- Failing to provide promised services

State laws regarding collection practices

Collection practices that may violate state laws vary from state to state, but may include

- Making repeated collection calls in an attempt to harass a borrower
- Calling borrowers at unreasonable hours
- Making false allegations when attempting to collect from a borrower

total amount owed, one multiplies the factor rate by the amount borrowed, for example, a \$50,000 advance multiplied by a factor rate of 1.2 equals \$60,000, the \$50,000 loan plus the \$10,000 fee.

However, the borrower may not realize that the factor rate is different from the annual percentage rate (APR) associated with traditional loans and credit cards in which the interest accrues on the declining principal amount as payments are made.

Given that the entirety of the interest is charged upon origination of an MCA, there is no cost savings associated with early repayment. In fact, the equivalent APR actually rises when the advance is repaid sooner. Assuming regular daily payments over the course of 12 months, the equivalent APR on this MCA would be around 40 percent; but if repaid in 6 months, the equivalent APR doubles to 80 percent. Although such APRs are quite high, usury laws in most states apply only to consumer loans. Moreover, because MCAs represent the cash purchase of future card revenue assets, they have generally been exempt from state and federal agency regulations governing traditional loans.

Borrower Protections

Small-business advocates have urged policymakers to consider regulatory intervention to protect alternative-finance-industry participants, especially borrowers. Some advocates promote the implementation of small-business-borrower protections similar to those in place for consumers. They note that in contrast to larger, established businesses with financial expertise on staff and long-term banking relationships, newer and smaller businesses often rely on the financial acumen of their owners and may have limited access to traditional credit. These small businesses increasingly are turning to a growing number of alternative-credit providers for their short-term financing needs.

However, there is evidence that some of the products are much more expensive than traditional credit and that their terms and conditions are not described clearly. Though industry leaders have argued that regulation would limit credit access to underserved small businesses, policymakers might seek to balance that risk with steps

Business owners, deemed more financially savvy than the average consumer, are not protected under the majority of consumer protection laws.

to ensure small-business credit is not merely available, but also affordable and easy to understand.

The newness of the industry and the lack of regulatory structure have given rise to questions about what, if any, intervention is needed and what supervisory authority agencies might have over small-business credit providers. In July, the US Department of the Treasury issued a Request for Information (RFI) seeking input on the business models of online alternative lenders, the potential for these lenders to reach the underserved, and the need for changes to the regulatory framework to support safe growth in the industry. The RFI prompted over 100 responses from industry participants and borrower advocates.

In November, members of the US Senate Banking Committee issued a letter to Treasury and Small Business Administration officials requesting greater clarity on the fintech industry, its role in the credit environment, and the need for greater transparency. Within it, the senators expressed particular interest in “understanding the opportunities, challenges, and risks in these emerging trends in small business capital.” ■

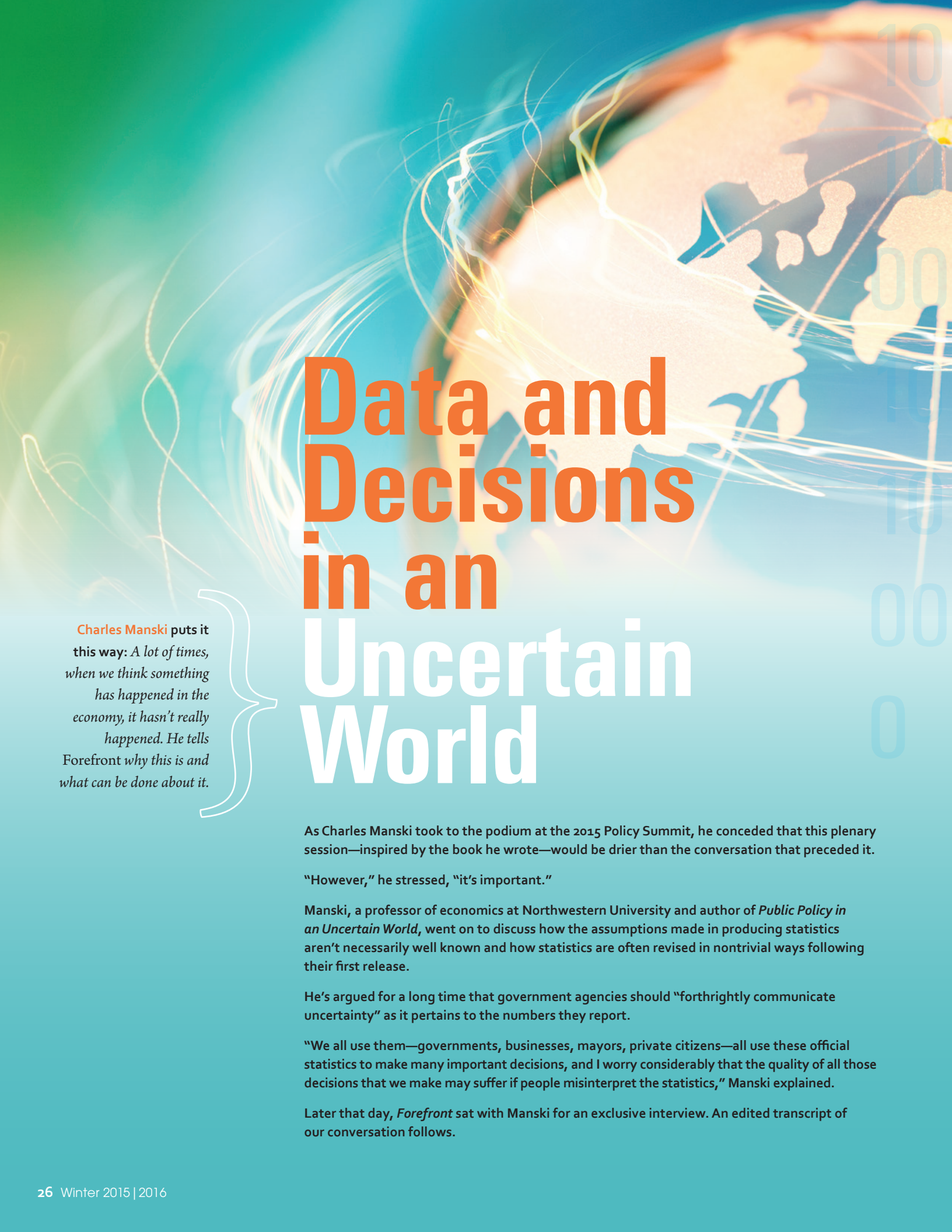
SUM AND SUBSTANCE

Small-business borrowers are increasingly turning to more expensive alternative financing, prompting calls for clear disclosures.



Read more

Want to learn more about alternative lending? See “Alternative Lending through the Eyes of ‘Mom & Pop’ Small Business Owners: Findings from Online Focus Groups” at <http://tinyurl.com/zvncnbf>.



Data and Decisions in an Uncertain World

Charles Manski puts it this way: *A lot of times, when we think something has happened in the economy, it hasn't really happened. He tells Forefront why this is and what can be done about it.*

As Charles Manski took to the podium at the 2015 Policy Summit, he conceded that this plenary session—inspired by the book he wrote—would be drier than the conversation that preceded it.

“However,” he stressed, “it’s important.”

Manski, a professor of economics at Northwestern University and author of *Public Policy in an Uncertain World*, went on to discuss how the assumptions made in producing statistics aren’t necessarily well known and how statistics are often revised in nontrivial ways following their first release.

He’s argued for a long time that government agencies should “forthrightly communicate uncertainty” as it pertains to the numbers they report.

“We all use them—governments, businesses, mayors, private citizens—all use these official statistics to make many important decisions, and I worry considerably that the quality of all those decisions that we make may suffer if people misinterpret the statistics,” Manski explained.

Later that day, *Forefront* sat with Manski for an exclusive interview. An edited transcript of our conversation follows.

"It's not that they make the stuff up, it's not that they're lying, it's not that it's fraudulent research. It's more subtle than that." (p. 29)

Forefront: *You said during your plenary a few times, when we think something has happened in the economy, it hasn't really happened. Explain how that's the case.*

Manski: Statistics come out and people take them seriously, and then the same statistic may get changed a month or 2 later, and something that we thought had happened actually didn't happen. A particular place where this happens is the quarterly estimates of GDP [gross domestic product] growth that come out from the Bureau of Economic Analysis [BEA] at the US Commerce Department. There's a whole sequence of these estimates: There's a first estimate and then a revision a month later and then a second revision 2 months later. And then at the end of the year, they get new data, and they revise it again.

It can often happen that the first estimate comes out and it looks

good—the economy grew at an annual rate of 3 percent, according to the estimate. And then a month later, new data come along and the BEA at the Commerce Department says, "Uh oh, the economy didn't really grow at a 3 percent annual rate. It actually grew at only 1 percent." Then a revision comes in 2 months later, and it's, "We need to change it again; actually, the economy contracted."

People are forming opinions about whether the economy is strong or weak based on the initial estimate, and then it turns out as the new data come in and they do revisions of the GDP data that it wasn't correct.

Now, this can have quite the implications. The regional Federal Reserve Banks participate with the Federal Reserve Board in making monetary policy. The Federal Reserve's Board of Governors is looking carefully at the GDP numbers trying to decide whether interest rates should be changed and so on, and the members of the Federal Open Market Committee could decide that interest rates should stay the same, perhaps

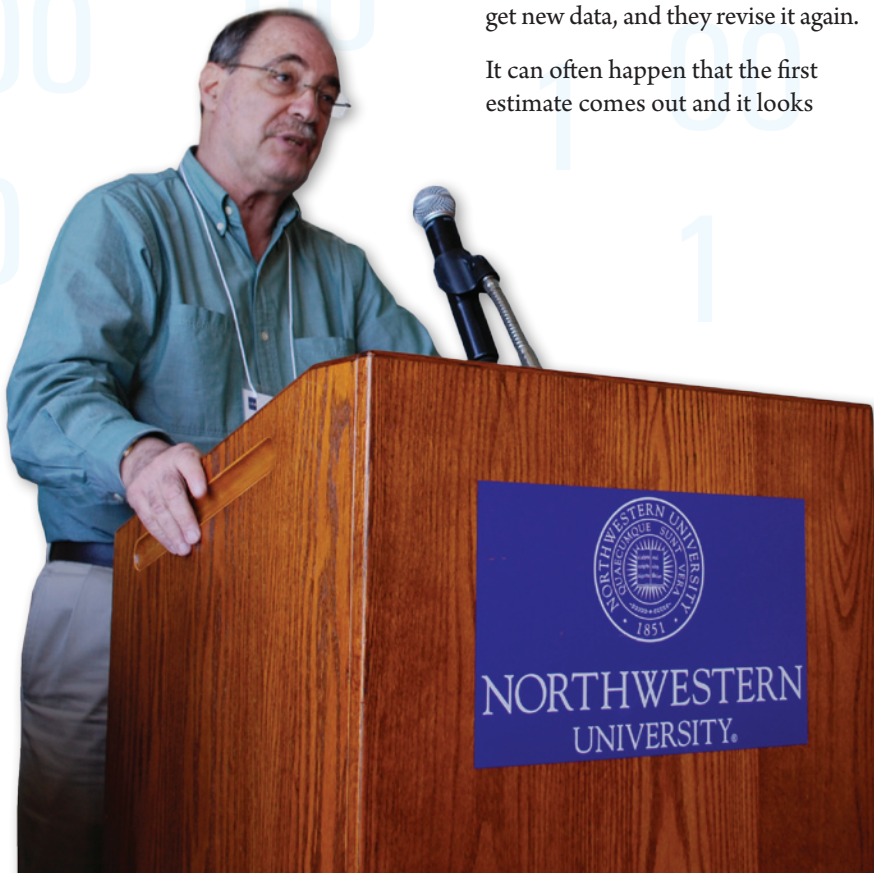


Photo courtesy of Northwestern University

because the economy looks one way, and then a month later they find out, “Uh oh, that was wrong.”

This happens quite frequently.

Forefront: *What specifically are you urging publication of as it pertains to uncertainties when it comes to data from the Bureau of Economic Analysis, the Bureau of Labor Statistics, the Census Bureau? Are you urging the publication of the bare necessities or something beyond that, and are you urging it for all data or just for certain kinds?*

Manski: In principle, I would like to have uncertainty expressed for all the statistics that the federal statistical agencies publish. But let’s focus on some of the most important ones like GDP growth, inflation statistics, unemployment rates, income distribution, and poverty rate. These particular statistics draw an enormous amount of media attention, and the public really pays a lot of attention to them. So let’s start with them. And the question is, “Well, what should we do?”

The agencies, the Bureau of Labor Statistics, Census Bureau, Department of Commerce, and so on, they put out news releases that get very wide distribution. For the news releases, you’re not going to go into deep, technical detail, but the public needs to have a sense of the uncertainty. I think a simple way to do it is to have a range. Instead of saying the GDP growth is 2 percent, try to measure the uncertainty and say the GDP growth seems to be between 1 and 3 percent. Similarly for the unemployment rate, instead of saying it’s 5.5 percent, say it’s between 5.3 percent and 5.7 percent.

The basic point is to get across some sensible notion of the magnitude of the uncertainty.

Now, that’s fine for the news release. For researchers, you need more than that. For the academic researchers, for firms making business decisions that really want to understand things better, then the statistical agencies could dig deeper and provide much more sophisticated measures of the uncertainty for those groups to use.

Forefront: *Why were you driven to write a book [Public Policy in an Uncertain World] on this particular topic? I imagine one of the reasons is that you see evidence all around you that people don’t pay enough attention to this issue, that you see risks building or some resulting consequences.*

Manski: I’ve always been interested in public policy. It has bothered me

People are forming opinions about whether the economy is strong or weak based on the initial estimate, and then it turns out as the new data come in and they do revisions of the GDP data that it wasn't correct.

Five years, 10 years might be enough to see how well a new policy is working in education or in social welfare or in other areas of that sort and then evaluate them and adapt them.

for many, many years that researchers publish articles claiming to know things that they don't really know. It's not that they make the stuff up, it's not that they're lying, it's not that it's fraudulent research. It's more subtle than that.

It's important to know that data alone don't tell you anything when you're trying to do research. You have to combine data with some kind of assumptions, some theory, about the way the world works. The subtleties of research are what kinds of assumptions people make that they combine with the data. There are huge incentives to get flashy results that will draw our attention. What that leads people to do is to combine the data that are available with very strong assumptions that allow them to draw strong conclusions.

The first thing I do when I read any piece of empirical research, I don't look at the findings; I look at what data were available and what assumptions were made and how the researcher combined the data with the assumptions. I was finding over and over and over again that the available data, which are never as strong as one would like, were being combined with assumptions that were not just strong but lack credibility.

At a point, about 5 or 6 years ago, I decided I really needed to reach out to a broader audience—that it's not sufficient for academic researchers to understand these issues; it's really important for the public to understand them because we're talking about very important public policy questions.

Forefront: *It's your assertion that maybe policy doesn't need to be static, that maybe if data are going to change, we should be flexible. So what horizon do we set? If data continue to be revised, how often do we change policy that's been set before we render ourselves paralyzed?*

Manski: If we admit that we don't know things and that we shouldn't be making policy once and for all for eternity, then how often should we be reevaluating things? It depends on the circumstance. Some policies are hard to reevaluate. An example that's current: California is beginning what could be a \$100 billion project to build a high-speed rail system that would go from Los Angeles to San Francisco. You can't really build

it piecemeal and see what happens. You have to build it all at once, and it's going to be a long time before that's reevaluated.

On the other hand, there are very different kinds of public policy, as an example, educational policy. What should class size be? What should be the role of educational testing? Well, you get a new cohort of students every year. We can have a much shorter time horizon in evaluating educational testing policies. Five years, 10 years might be enough to see how well a new policy is working in education or in social welfare or in other areas of that sort and then evaluate them and adapt them. The adaptations don't have to be a wholesale changing of a policy. They can be fiddling at the margin and making refinements.

The idea that I specifically recommended—what I've called “adaptive diversification”—would allow one to do this in a continuous way. Let's use the example of evaluating schools by test scores or not. Some schools could be under a testing regime and other schools could be not using a testing regime. They're very different policies, but what you could evaluate smoothly is the fraction of schools that are using a testing system or are not using a testing system.

As the evidence accumulates, you could modify the fractions. So in the beginning when you don't really know, maybe half the schools get one policy and half get the other. As the data accumulate and it looks like one policy's working better than the other, you go from 50/50 to 60/40 to 70/30, and then when you finally feel comfortable enough that one policy is really the best, then everyone gets that policy.

Forefront: *Is there a particular use of data without quantification of error or without identification of a probable range that makes you cringe the most? Or is there one that you really like?*

Manski: Let me talk about a case where I think at least there's a good-faith effort to do it well. It's not perfect by any means, but I think we could learn from it.

Climate change is a matter of enormous controversy. It is not a matter of economics, but it certainly impinges on the economy. There are thousands of scientists that try to do forecasts of climate change and try to understand what the effects of policy changes would be on the climate. The United Nations has had this organization called IPCC [Intergovernmental Panel on Climate Change]; it's an international committee of scientists that's supposed to do forecasts of climate change. They have tried to be very careful in trying to separate what are the things that we think we know really well, where we can say, "Yeah, that's it," and we can just go with a point estimate on that, and what are the things that we don't

really know very well but maybe we can quantify it enough to put a probability distribution on it.

But then they have a third category of things that are really so uncertain that we don't even want to put probabilities on them. In my literature, in economics, we talk about that as "ambiguity." The scientists who do work on climate change, they call it "deep uncertainty." They are the parts of climate change that are so uncertain that we just have to say, "Well, it could be this scenario or it could be another scenario, but we can't even put probabilities on it." I think that's a nice model. ■

—Michelle Park Lazette

SUM AND SUBSTANCE

Data can change materially after initial publication.

Charles Manski

Position

Northwestern University Board of Trustees Professor in Economics, Department of Economics Fellow, Institute for Policy Research, Northwestern University

Recent books

Public Policy in an Uncertain World: Analysis and Decisions

Cambridge: Harvard University Press, 2013

Identification for Prediction and Decision
Cambridge: Harvard University Press, 2007

Social Choice with Partial Knowledge of Treatment Response

Princeton: Princeton University Press, 2005

Education

Massachusetts Institute of Technology
BS in Economics, 1970

Massachusetts Institute of Technology
PhD in Economics, 1973



Photo courtesy of Northwestern University

On the reel



Watch Charles Manski speak to the "enormous responsibility" he says the media bear in communicating uncertainty to the public. In another short video, he explains why he's more concerned with one form of error than another.

<http://tinyurl.com/qf4bnxa>

Here to Learn

At the 2015 Policy Summit, practitioners and researchers dug deep into the need for safe and affordable housing, better education, and equitable change.



Tasia Hane-Devore
Staff Writer

Contributors to the most recent Policy Summit, sponsored by the Federal Reserve Banks of Cleveland, Philadelphia, and Richmond, highlighted the interconnectedness among workforce development, affordable housing, and access to education, quality healthcare, and technology infrastructure.

The central theme of the summit was how equitable development can benefit low- to moderate-income communities. Representing 25 states, more than 340 people attended the 2-day summit held in thriving downtown Pittsburgh. The talk of economic challenges faced regionally and nationally resonated with community practitioners and researchers and provided evidence that the nation is attuned to the need for collaboration across, not just within, individual sectors in order to meet equitable development goals.

The ways cross-sector collaboration and initiatives can contribute to disrupting the cycle of poverty were discussed at length, including during the opening plenary featuring Mayor William Peduto and former Cleveland Mayor Jane Campbell. Cities across the nation are being tasked with pursuing social mobility and economic growth that promotes opportunities for all residents, not merely a few. Essential to growth are educational opportunities and collaborative efforts to coordinate talent and skill sets with the needs of employers—without each student’s racking up tens of thousands of dollars in student loan debt.

Tying skills pathways to a region’s economic drivers is also essential. The skills gap, the difference in on-the-job skills required and the skills employees possess, was the topic of the keynote speech offered by Cleveland Fed President Loretta J. Mester. She noted that technological change has driven demand for skilled workers relative to unskilled workers. “Even industries often viewed as less skill-intensive have increased their demand for skilled labor,” said Dr. Mester. “The manufacturing plant of the

1970s has transformed itself into a high-tech operation, requiring workers who can operate computerized machinery and even robots.”

But education and skills training aren’t the only necessary components to building a more equitable and upwardly mobile society. Neighborhood revitalization is important, too. In speaking of one success story, Pittsburgh’s East Liberty neighborhood, Rob Stephany, director of community and economic development at The Heinz Endowments, asserted that embracing neighborhood culture is essential for successful revitalization, as is a community-driven plan with participation from and collaboration within all levels of government.

Equitable access was a primary theme of the summit, as was the necessary interconnectedness between people and livable, workable space; among technology infrastructure and education and workforce-skills development; between health and environment; and across all these areas of concern.

Kwanza Hall, a councilmember representing District 2 in the City of Atlanta, found it humbling to be “part of this cohort and a part of this conversation. Often elected officials get to this point much later in the game.”

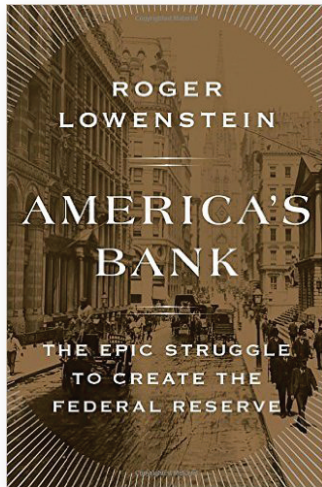
He, like others who attended, is looking forward to taking the ideas gleaned from other conference participants and attendees and converting them to action in his home region. “To know practitioners as well as researchers,” Hall said, “gives me an open book to new friends that I can call on whether they be in my home district or not.” ■

Experience it



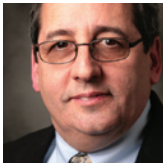
Conference participants slipped into others’ shoes for an hour of simulated poverty. Watch and read about their experiences: <http://tinyurl.com/ph24ynh>

A 2-hour tour can change your perspective: One Pittsburgh neighborhood has come a long way. To see East Liberty, go to <http://tinyurl.com/qcd34r4>



America's Bank: The Epic Struggle to Create the Federal Reserve

by Roger Lowenstein
Penguin Press, NY, 2015



Reviewed by
Dan Littman
Policy Advisor

Watershed events in public policy are often reduced to a few paragraphs or pages. Such treatments necessarily focus on social movements, the actions of political parties or voting blocks, and major economic events. The policy changes thus gain an air of inevitability in terms of their occurrence, timing, and final shape.

It's the usual treatment given to the founding of the Federal Reserve System in 1913. But the Federal Reserve was not inevitable, nor were its decentralized structure and governance details. Creation of the Fed is typically clustered with other legislative actions and tagged "Progressive Era reforms," representing "progress" in the US banking system, though leading lights of Progressivism might disagree with that designation.

Roger Lowenstein's *America's Bank: The Epic Struggle to Create the Federal Reserve* is an outstanding book on

the founding of the Fed, accessible to the lay reader and satisfying to the expert. Focusing on the primary actors in bringing the Fed into being and on the period of 1907 to 1914, Lowenstein dispels the air of inevitability surrounding the Fed and its structure. The book's great contributions come from examining the individuals involved and through mining primary materials such as letters, diaries, memoirs, early versions of the Fed proposal, and the records of congressional hearings.

Among the notable figures in the book are Nelson Aldrich, the US senator who guided the proposal during 1908–1912, and Paul Warburg, a German-born banker who generated many of the ideas that, diluted and modified, form the basis of today's Federal Reserve Act. Other important figures in the book include Frank Vanderlip, JP Morgan, Carter Glass, and Woodrow Wilson. By focusing on individuals and their actions rather than on social movements, Lowenstein is able to answer many questions about the founding of the Fed.

The Panic of 1907 did start a process that ended with the creation of the Fed, but the Aldrich–Vreeland Act of 1908 was the immediate policy response. It took 6 years from the October 1907 Panic for the Federal Reserve Act to pass and 7 years to establish the Reserve Banks.

By focusing on individuals and their actions, Lowenstein is able to answer many questions about the founding of the Fed.

Lowenstein demonstrates that key figures found the Panic of 1907 especially frightening because of its small beginnings and subsequent depth and breadth. Within weeks of the failure of a single New York bank, clearing houses in more than 250 cities around the US had suspended or restricted cash withdrawals from checking accounts, and many clearing houses had issued “scrip” as substitutes because cash supplies were unavailable.

Lowenstein demonstrates that figures such as Aldrich, Warburg, and Vanderlip exploited the reform opportunity of the Panic and began the march toward a US central bank, the first since 1836. There had been strong reform sentiment among bankers from large and small banks since the 1880s, but this sentiment hadn’t gained traction in Congress. Large New York-based banks were more sympathetic with Paul Warburg’s early proposal, modeled on the centralized, mostly banker-run models then in place in Europe. Banks outside of New York, especially small-town banks, did not view the New York banks as their natural allies. However, Aldrich was able to gain support from these disparate bank groups. This behind-the-scenes coalition building was much like the United States’ recent experience in which long-time supporters of more coherent consumer protection in banking took advantage of the Panic of 2008 and its aftermath to embed the Consumer Financial Protection Bureau into the Dodd–Frank Wall Street Reform and Consumer Protection Act.

The final version of the Federal Reserve Act was similar to the bank-led Aldrich Plan in terms of the Fed’s structure. Lowenstein shows that the group around Nelson Aldrich, and Aldrich himself, was very aware of the political forces around banking and bank regulation in the United States, as well as the constraints American political culture and geography imposed on any design. The Aldrich Plan envisioned many offices across the US—semi-autonomous in some respects, including their clearinghouse (check) and cash distribution activities and, possibly, discount window lending—all reporting to a central office and a largely banker-led governance structure.

As the Aldrich Plan moved into Congress, a governance structure of bankers-only quickly transformed into one with bankers, other community and business leaders, and the federal government. The core group involved in the Jekyll Island conference, where the Aldrich Plan

was drafted, was sympathetic to this change; members understood political realities and the need for compromise to create a central bank. A regional structure with many branches was changed into a regional structure with 12 semi-autonomous Reserve Banks.

An almost complete version of what became the Federal Reserve Act was thus in shape in 1912, waiting for the right moment in Congress. With Woodrow Wilson’s gaining the presidency, the stage was set. Lowenstein shows that Wilson was not a typical Democrat of his day, but a closet Hamiltonian, believing Andrew Jackson’s destruction of the previous US central bank in the 1830s was bad policy. But having secret sympathy for a central bank was not enough to overcome opposition in Congress, mostly from Wilson’s own Democrats.

The process from the Panic of 1907 to passage of the Federal Reserve Act is peppered with compromises and negotiations by leaders who understood the value of such approaches, even if the final outcome wasn’t precisely what they had in mind.

Yet Wilson was masterful, convincing influential congressional leaders and his own secretary of state, William Jennings Bryan, to support the bill. Bryan was especially turned to support by Wilson’s adding a capstone to the structure, the Board of Governors.

America’s Bank is an important read for Federal Reserve staff, for bankers, and for the general public. It helps the reader understand the political reasons for our central bank and its 13 separate legal entities, the 12 Reserve Banks and the Board, and provides perspective regarding how the Fed makes policy and business decisions. The process from the Panic of 1907 to passage of the Federal Reserve Act is peppered with compromises and negotiations by leaders who understood the value of such approaches, even if the final outcome wasn’t precisely what they had in mind. This is the lesson of most landmark bills that have made their way through Congress over the last 250 years—and it’s a lesson Washington-watchers should keep in mind. ■

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