WINTER 2011

CENTRAL Banker

NEWS AND VIEWS FOR EIGHTH DISTRICT BANKERS

FEATURED IN THIS ISSUE: Are We in a "Jobless Recovery"? | Many Community Banks Still Struggling with Crisis Fallout

In-Depth Public Discussions Explore the Financial Crisis, Federal Deficit and Unemployment

Will the Dodd-Frank Act lessen the impact of future financial shocks? Could the debt crisis in Europe trigger a recession here? Why is the unemployment rate barely moving even though jobs are opening up? What is driving the federal deficit?

These are among the concerns the public raised during the St. Louis Fed's fall discussion series, "Dialogue with the Fed: Beyond Today's Financial Headlines." Hundreds of guests came to the Bank on Sept. 12, Oct. 18 and Nov. 21 to see the presentations and engage in open discussions with experts from the St. Louis Fed. The public series proved so popular that the final two sessions were webcast live via the Bank's web site.

"We noticed a significant increase in interest from the general public for current financial and economic information from the Federal Reserve," said Julie Stackhouse, senior vice president and managing officer for Banking Supervision, Discount Window Lending and Community Development. "We decided the best way to connect the public with the expertise here at the Fed was to engage them directly. The goal of the series was to provide the public with relevant and timely information as well as a forum for discussion of current issues. Based on the feedback we received, I think we addressed this need."

Although Dialogue organizers had no shortage of possible topics related to the financial crisis and Great Recession to discuss—including the sluggish recovery, a stagnant housing market and the downgrade of the U.S. sovereign debt rating—they focused on three specific and critical themes. As explored in this issue of *Central Banker*, the session topics were:

1. the origins of, responses to and lessons learned from the financial crisis;
2. the federal budget deficit and the hard choices that must be made regarding taxes and spending;
3. and the current unemployment situation in the United States.

Visit **www.stlouisfed.org/dialogue** to view the presentations and videos, including the question-and-answer sessions. Information on future Dialogues will appear there soon.

DIALOGUE WITH THE FED

Beyond Today's Financial Headlines

CENTRAL
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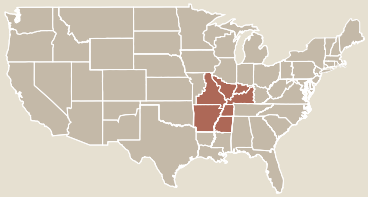
The Eighth Federal Reserve District includes all of Arkansas, eastern Missouri, southern Illinois and Indiana, western Kentucky and Tennessee, and northern Mississippi. The Eighth District offices are in Little Rock, Louisville, Memphis and St. Louis.



Useful St. Louis Fed Sites

Dodd-Frank Regulatory Reform Rules
www.stlouisfed.org/rrr

FOMC Speak
www.stlouisfed.org/fomcspeak

FRED (Federal Reserve Economic Data)
www.research.stlouisfed.org/fred2

St. Louis Fed Research
www.research.stlouisfed.org

CENTRAL VIEW

Dialogues Bring the Fed and General Public Together

By David Sapenaro

David Sapenaro is the first vice president and chief operating officer of the Federal Reserve Bank of St. Louis.

The recently completed "Dialogue with the Fed" series is a new means to engage an important Bank constituent: the general public. We have long held these types of events for other Bank constituents, such as business leaders, bankers and local governmental officials, but this was the first time we had events targeting a more general audience.

We believe that it is important for the general public to have access to experts who can explain important and often complex economic situations and information in layman's terms—especially in an open forum. We also want the public to have a better understanding of what the Federal Reserve does, why we do it and how we do it and to see firsthand that we are committed to working in the public's interest. The Dialogues appear to have been effective on all of these fronts because the events were well-attended and, based on feedback from participants, well-received.

Over the past several years, the Bank has emphasized the importance of external outreach, both in person and through electronic means. Our Bank officials and economists devote time each year to meet face to face with constituents throughout the Eighth District to share information and seek anecdotal feedback on the economy and other pressing financial and banking-related issues.

In addition, we have significantly enhanced our web sites and begun using social media tools to provide timely and high-quality economic and financial information. And we have expanded and augmented our outreach to specific constituents, such as teachers and community development professionals, to provide information and materials to help them better perform their responsibilities.

Visit **www.stlouisfed.org** for more information about our events, programs and economic research. Also, please visit **www.stlouisfed.org/followthefed**, where you can use Twitter, Facebook, RSS feeds and more to keep track of the latest information and data.

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IN-DEPTH

Can Lessons from the Recent Financial Crisis Help Avoid Future Crises?

DIALOGUE WITH THE FED

PART 1

Even though financial crises, recessions and depressions are nothing new in America, the severity of the 2007-2009 recession and ensuing financial crisis highlighted some weaknesses in our financial system and gaps in our regulatory system.

On Sept. 12, St. Louis Fed officials and a public audience explored the causes of and responses to the financial crisis during the first "Dialogue with the Fed" discussion, "Lessons Learned from the Financial Crisis." Julie Stackhouse, senior vice president and managing officer for Banking Supervision, Discount Window Lending and Community Development, led the presentation and discussion. Joining her for an audience question-and-answer session were Mary Karr, the St. Louis Fed's general counsel, and economists William Emmons and Silvio Contessi.

Underlying Causes and Lessons

According to a December 2009 congressional report, the chain of events leading to the severe crisis in the fall of 2008 began with an asset bubble in housing, expanded into the subprime crisis, escalated into a severe freeze-up of the interbank lending market, and culminated in intervention by the U.S. and other industrialized countries to rescue their respective banking systems.

Numerous assumptions, miscues and efforts to transfer risk to other parties combined to trigger the crisis. As Stackhouse explored in her presentation, several lessons have been culled from those underlying causes.

Lesson: Misguided Comfort

High levels of debt, uncertain ability of borrowers to repay debt and an expectation that housing prices will always increase (among other factors) created a comfort level that was misguided.

"Too much debt that does not have a clear ability to be repaid and is dependent on an asset—typically land—going

continued on Page 4

FIGURE 1

FIRST RESPONDERS TO THE FINANCIAL CRISIS

Federal Reserve

- Provided funds (liquidity) to stabilize financial markets through several credit and lending facilities and programs

United States Government

Funded:

- Troubled Asset Relief Program
- $800 billion economic stimulus
- Cash for Clunkers program
- Homebuyer tax credit
- Extended unemployment benefits

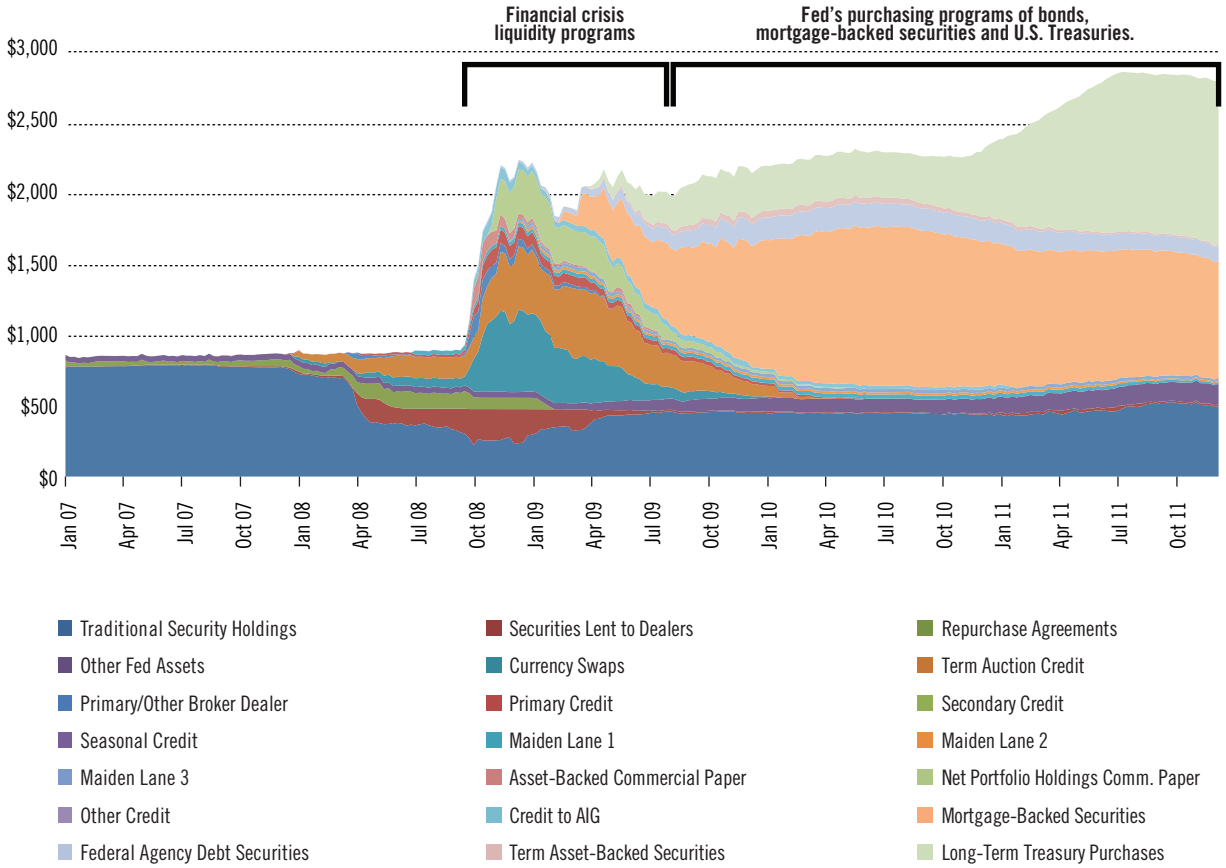
Federal Deposit Insurance Corp.

- Raised bank deposit insurance limits
- Provided other bank debt guarantees

FIGURE 2

Federal Reserve Credit Easing Policy Tools

Weekly, January 2007 - August 2011, in billions of dollars



SOURCE: Federal Reserve Board

Lessons

continued from Page 3

up in price is a recipe for disaster," said Stackhouse. "We like to think that values will always increase over time; we need to begin to think that they might not. And you have to be able to repay your debt—particularly when it's a big debt on your balance sheet.

"This is one of those lessons that has to be learned and relearned and relearned. And the risk was a lot harder to see this time around because it was so spread out over the financial system," she said.

Lesson: Misunderstood Risk

Risk needs to be understood across all parts of the financial system, including banks and nonbanks. Spreading risk outside of the insured banking system and the use of "insurance" policies, such as credit default swaps, did not result in risk diversification.

Why, though, didn't the Fed see it? "Our regulatory structure was not built to see this risk," she said, because different agencies oversee different components of the financial industry. Not all risk is found in banks; many times, risk is in financial institutions that aren't banks, such as insurance companies and investment houses (the so-called shadow banking system).

Stemming from this lesson, a new Financial Stability Oversight Council was created by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The council is charged with monitoring risk across all financial sectors. If the council identifies a new systemically important financial institution, it will be supervised by one regulator, the Federal Reserve.

Lesson: Short-Run Choices

Choices made in the short run may have long-run consequences that need to be carefully considered.

> "That is our role: providing financial stability by being there to stop the panic but stepping out when the panic is done."
>
> —Julie Stackhouse

During the housing bubble, many looked upon owning a home as a means for building wealth for retirement, based on the assumption that prices would always go up. "But if building wealth for retirement was a goal, then there were probably better and more certain choices than investing in a home," Stackhouse said. "Looking back, it's a simple lesson but probably one that we looked over a bit too quickly."

Panics *Can* Be Stopped...

In the fall of 2008, the Federal Reserve, the federal government and the Federal Deposit Insurance Corp. (FDIC) started using many tools to combat and stop the financial crisis. (See Figure 1 on Page 3.) The Fed repeated and expanded on a measure last used immediately after the 9/11 attacks: It injected liquidity via credit programs and loans to banks and financial organizations to get the financial markets moving again.

As Figure 2 on Page 4 shows, the Fed's balance sheet was fairly steady until the crisis became acute in fall 2008. The Fed initiated many lending facilities and used other long-standing liquidity measures, including working with foreign banks.

"That is our role: providing financial stability by being there to stop the panic but stepping out when the panic is done," Stackhouse explained. "What's not well-understood is that although the balance sheet got very large and peaked at a high level in the late winter of 2009, the programs enacted in response to the crisis have largely gone down to zero. Today there is very little left on the Federal Reserve's balance sheet from the financial crisis programs."

As seen in Figure 2, what's left on the balance sheet—the large amounts from early 2009 to the present—represents the Fed's efforts to stimulate the economy by purchasing bonds, mortgage-backed securities and U.S. Treasuries.

During the question-and-answer session, Emmons added that central bank liquidity—both here and abroad—ideally should be used only for emergencies. "We don't want the central banks to be the only providers of liquidity—they're the lenders of last resort," he said. "We want the interbank markets to be the primary—almost exclusive—sources of liquidity. That lack [of a strong interbank market] is the problem in Europe right now."

...But Will It Work in Europe?

Previous experiences demonstrate that actions of central banks can stop a crisis in its tracks. But because of debt woes in Greece, Italy, Spain and other nations, Dialogue audience members were eager to know whether events in Europe threatened a new crisis that could spread to America.

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Did the 1999 Gramm-Leach-Bliley Act Cause the Crisis?

During the Sept. 12 "Dialogue with the Fed," some audience members questioned whether previous government and regulatory actions not only fueled the crisis but also need to be undone to prevent a future crisis. One person asked whether the Dodd-Frank Act sufficiently addresses the lack of separation between commercial banking and investment banking; the 1933 Glass-Steagall Act created the separation, but it was repealed as a result of the 1999 Gramm-Leach-Bliley Act.

According to some economists, policymakers and lawmakers, the repeal helped create the subprime mortgage crisis and "too big to fail" financial institutions, but Fed economist William Emmons noted the lack of consensus behind that argument.

He pointed to the extraordinary September 2008 actions involving four large financial organizations: The federal government took over Fannie Mae and Freddie Mac; allowed the investment firm Lehman Brothers to go bankrupt; and bailed out AIG, one of the world's largest insurance companies. "None of them," Emmons said, "had anything to do with Glass-Steagall, and they were unaffected by the act of 1999."

The Fed's Julie Stackhouse added: "The reason why Glass-Steagall was repealed is because investment banking and commercial banking became so intertwined they couldn't be separated easily. Many investment banking activities support prudent commercial banking activities."

One of the components of the Dodd-Frank Act, the pending "Volcker Rule," is meant to address issues related to the 1999 act, such as proprietary trading. The public can comment on the proposed Volcker Rule until Jan. 13, 2012. Go to the "Open for Comment" section at **www.stlouisfed.org/rrr** for more information on the rule.

FED FACT

Congress first authorized the Fed's liquidity actions under the Federal Reserve Act of 1913.

Lessons

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Speaking specifically of the situation in Greece, Contessi said it wasn't clear whether a crisis could be contained. "The direct exposure of the U.S. to the Greek financial system is small, but there is a lot of indirect exposure. Obviously many European banks own Greek debt, and there are bilateral relationships between U.S. and European banks," he said.

"If any of those countries default, then the value of the Treasury bonds that banks hold may be very different within a few days of default. So, there is a chance that things could turn ugly," he said.

"Direct and indirect exposure is where contagion comes from; that's where panic is very dangerous," Stackhouse said. "But that's also where central banks step in to calm the fears by making sure that payments can be made where solvency otherwise exists. And of course the hard thing to judge is when solvency exists."

In Sum: What Did the Financial Crisis Teach Us?

Unrealistic comfort levels, assumptions, miscues and the failure to appreciate industry-wide risks converged to trigger the financial crisis. The Dodd-Frank Act is designed to deal with those shortcomings and help prevent a similar crisis in the future, but its costs and impact on the financial industry are not yet known.

Meanwhile, the Fed, along with the federal government and FDIC, proved once again that major financial crises are stoppable. Most of the Fed's liquidity measures for the crisis itself have since fallen off the Fed's balance sheet. And even though financial events in Europe could spread to the U.S., central banks still have the ability to inject liquidity into the markets.

While there is no magic bullet to prevent all financial crises, there is vigilance: "Risk will be something different tomorrow than it is today. The challenge will be to identify what the next thing is so that it doesn't get ahead of the system designed to watch over it," Stackhouse said.

>> MORE ONLINE

Financial Crisis Timeline
http://timeline.stlouisfed.org

Liquidity Crises in the Small and Large
www.stlouisfed.org/liquidity

Federal Reserve Balance Sheet Information
www.federalreserve.gov/monetarypolicy/bst.htm

Many Community Banks Still Struggling with Crisis Fallout

The financial crisis officially ended in 2009, but many banks are still struggling, a situation that concerned some audience members during the Sept. 12 "Dialogue with the Fed" discussion.

The subprime mortgage market has largely disappeared, and significant challenges remain in the housing market: Seriously delinquent or in-foreclosure mortgages are backlogged and must be worked through the pipeline.

"There are massive numbers of home equity loans out there," the St. Louis Fed's Julie Stackhouse said to members of the audience. "If a mortgage defaults, then the home equity loan is almost a total loss."

Hundreds of the nation's 7,000 community banks are still having troubles. "That's one of the things we worry about: It's just going to take time to work through the problems because inevitably every one of those banks has a lot of real estate loans on its books. When you have that problem, those banks are not in the business of doing new lending—which is frustrating for many of you looking for credit."

On the positive side, Stackhouse noted, are the thousands of community banks that are fairly healthy. "Those are the ones in the lending game," she said. "The question going forward for all banks is whether borrowers can meet banks' tighter loan standards."

Ever-Higher Taxes or Ever-Higher Debt?

Exploring Scenarios and Possible Solutions to the Federal Budget Deficit

DIALOGUE WITH THE FED

PART 2

Since the end of World War II, the U.S. had been fairly successful at managing its debt and deficit. However, inadequate tax revenues for most of the last 30 years, the shock of the financial crisis and looming fiscal challenges related to the aging U.S. population and rising health care costs have left the U.S. with a more than $1.3 trillion fiscal gap between revenue and outlays.

While a number that size may seem insurmountable, one St. Louis Fed economist suggests that a solution is still well within our reach—but *only* if lawmakers and citizens make hard choices now *and* stick with them.

The deficit was just one of the stark figures presented during the second "Dialogue with the Fed" on Oct. 18, "Bringing the Federal Deficit under Control." St. Louis Fed economist William Emmons led the presentation and discussion. Joining him for a question-and-answer session with the attendees were Christopher Waller, senior vice president and director of Research, and Julie Stackhouse, senior vice president and managing officer for Banking Supervision, Discount Window Lending and Community Development.

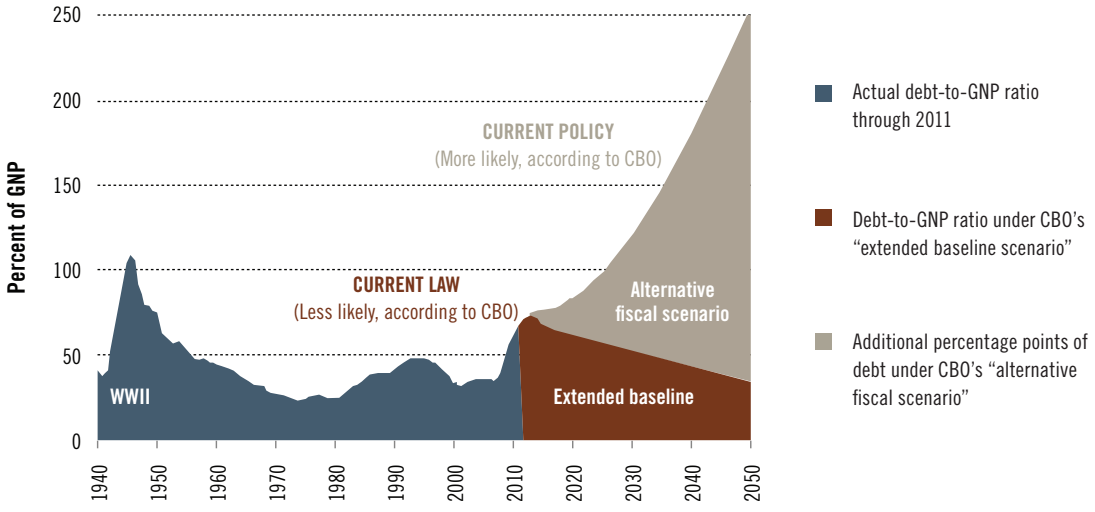
A $1.3 Trillion Deficit

"We have an extreme situation of very large budget deficits," Emmons explained. According to an August 2011 Congressional Budget Office (CBO) report, the United States is facing "profound budgetary and economic challenges," which Emmons described as "the most accurate statement of the seriousness of the budget situation."

CBO figures anticipate that the fiscal gap between revenue and outlays will be equivalent to $1.3 trillion dollars every year between now and 2085 if the nation continues on its present course. To see what may happen, Emmons explored the CBO's two markedly different scenarios for deficit control.[1]

continued on Page 8

Two Scenarios for Debt Held by the Public



NOTE: The CBO's August 2011 baseline reflects the effects of provisions related to the Congressional Joint Select Committee on Deficit Reduction.

SOURCES: Office of Management and Budget (OMB), Congressional Budget Office (CBO)

Taxes or Debt

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Current-Law Scenario: Ever-Higher Taxes

The CBO's extended-baseline, or current-law, scenario assumes that all provisions of laws currently on the books will be fulfilled on schedule in 2011 and 2012. This includes reverting tax rates to year 2000 levels, ending the one-year payroll tax reduction and ending the temporary limitations on the alternative minimum tax. Spending caps and cuts currently on the books, including those mandated by the Budget Control Act of 2011, would need to be enforced.

"Current law *would* reasonably shrink long-run deficits and reduce debt levels relative to the size of the economy in three to five years, with the deficit of about 2 percent of GDP," Emmons said. "*However*, it would mean that revenues as a share of GNP would continue rising indefinitely.

"Tax revenues would increase at double-digit percentage rates for each of the next three years at 12 percent or more and then would continue to grow faster than the economy. It's a windfall for the federal government," Emmons said.

The restoration of higher marginal tax rates, "bracket creep" and the alternative minimum tax will play a large role in ever-rising taxes. "So, yes, current law solves the budget problem but in a fairly unpleasant way," he said.

Alternative Fiscal Scenario: Exploding Debt

The CBO warned in August 2011 that certain provisions of current law are either widely expected to change or would be politically and economically difficult to sustain for a long period.

Therefore, the CBO created an alternative fiscal scenario based on current policy (not current law), assuming that many current-law provisions will not be enacted. The temporary revenue and outlay measures would not expire as planned, and most of the spending caps would not begin. Based on recent experiences and current policy, the CBO suggests that deferring painful choices would produce a large and growing mismatch between revenue and outlays, resulting in a massive increase in debt.

"At some point, investors might refuse to buy the expanding stock of Treasury debt, resulting in a debt crisis that would push interest rates sky-high," Emmons said. "If hard choices continue to be deferred, about half of all national income would be needed simply to pay the interest on federal debt by the end of the 21st century."

The Supercommittee and Other Ideas

If either CBO scenario is unpalatable, what can be done? Congress' latest deficit reduction attempt, the Budget Control Act of 2011's supercommittee, ended in deadlock on Nov. 21. According to the act, the bipartisan supercommittee's failure to submit proposals is supposed to trigger an automatic $1.2 trillion in deficit reduction measures starting in January 2013.

Meanwhile, opinion polls consistently indicate that the majority of the public believes that the economic pain of increased taxes and spending cuts should be shared by all income levels, including spending reductions for Social Security and Medicare. Dialogue audience members generally agreed.

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FED FACT

The Fed is responsible for monetary policy, but Congress controls fiscal policy, which involves taxes and spending.

Could More Debt-Financed Stimulus Reduce the Deficit?

The Oct. 18 Dialogue audience members wondered whether more short-term, debt-financed stimulus would be an effective deficit-fighting tool.

The St. Louis Fed's Christopher Waller replied that there is no clear consensus on whether such stimulus spending has a significant impact on the economy. "If you borrow a dollar to spend a dollar on government spending, the amount of GDP you increase is small or zero—you're borrowing a dollar from someone who would have spent it anyway. So, essentially, you're not changing anything.

"There is a lot of evidence that it's not that powerful of a tool to get the economy going. On the other hand, a lot of economists think that it has huge effects, but so far we don't seem to see it in the data yet," Waller said.

What's Not Working This Time Around?

Third Dialogue Examines Why Unemployment Remains High

DIALOGUE WITH THE FED

PART 3

The nation lost more than 9 million jobs during the Great Recession, and the unemployment rate has been stuck around 9 percent for more than two years. Companies, uncertain about the recovery, remain reluctant to hire, and millions of job seekers have stopped looking for work entirely.

Because the employment situation has been so frustrating and confusing, the St. Louis Fed hosted "Understanding the Unemployment Picture" on Nov. 21 to offer insight on this issue and answer attendees' questions. As part of the "Dialogue with the Fed" series, Christopher Waller, senior vice president and director of Research, led the presentation and discussion, with assistance from economists David Andolfatto and Natalia Kolesnikova.

The Causes Are Many

Most recessions between World War II and the Great Recession had several things in common. For example, after a sharp spike in unemployment, housing starts and sales would lead the recovery and unemployment would decline in response to monetary or fiscal policies. That pattern did not occur this time around.

Unemployment doubled between January 2008 and October 2009, and

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Taxes or Debt

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Also, many legislators, economists and even Fed Chairman Ben Bernanke agree that the deficit must be controlled to ensure economic stability. Alternatives include increasing tax revenue and efficiency, cutting mandatory and discretionary spending, reducing the growth of health care costs, and promoting reforms focused on growth and economic stability. "There can be no sacred cows in the budget," Emmons said.

The supercommittee's inability to reach a consensus illustrates that nothing will fundamentally change unless the government actually makes the hard choices and sticks with them, Emmons insisted. "The supercommittee is a new version of an old game: We'll promise to make these changes in the future—but then we'll see if we actually make them," he said.

In Sum: Will We Make Hard Choices?

Neither the current-law nor the current-policy scenario that the CBO created would produce an ideal outcome because the former would mean ever-higher taxes and the latter would mean ever-rising debt.

The general public appears open to a combination of tax hikes and spending cuts. Those sentiments are echoed by advocates of broad-based spending reductions and efficiency- and revenue-enhancing tax reforms, which include controlling health care costs and reforming the budget process.

"This isn't like a technology problem that we have to send engineers to figure out," Waller said. "You cut spending, raise taxes or both—that's it. But do you have the political will to do it?"

>> MORE ONLINE

FRED Charts on the Gross Federal Debt
www.stlouisfed.org/FYGFD

Questions about the Budget Deficit Have No Easy Answers
www.stlouisfed.org/deficitanswers

ENDNOTE

1 Both of the CBO's scenarios are based on a rate of inflation of about 2.5 percent CPI, with a similar economic growth rate, and interest rates of 10-year U.S. Treasuries at 5 percent. Note that the alternative/current-policy scenario does not reflect provisions related to the 2011 Budget Control Act's bipartisan supercommittee.

Not Working

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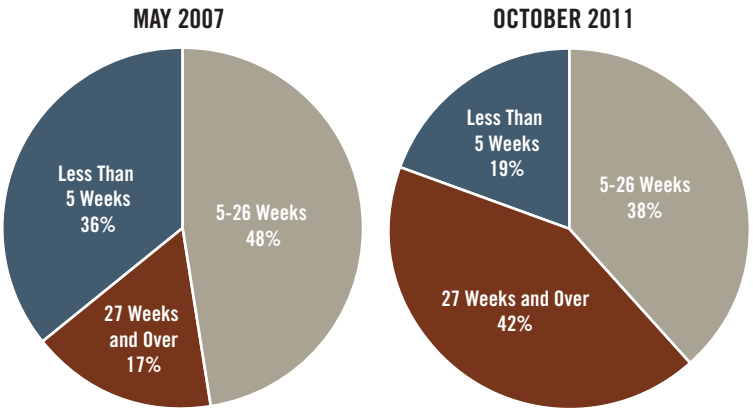
more than two years after its peak of 10.2 percent, the unemployment rate has fallen only about 1.1 percentage points. "In 2008-2009, we lost 750,000 jobs for six straight months. That's why it's called the Great Recession," Waller said. "These numbers are staggering, and it means we've dug a very big unemployment hole."

Several interrelated factors are contributing to high unemployment:

Housing isn't leading the recovery. The collapse of the housing market was one of the primary drivers of the financial crisis and Great Recession. After effectively building 12 years' worth of houses in five years, this sector alone lost nearly 2 million jobs, with peripheral industries losing another 800,000. "What we're seeing is a big recession heavily dominated by one sector," Waller said.

Unemployment Duration

Unemployment spells are much longer for many



NOTE: Due to rounding, numbers do not equal 100 percent.

SOURCE: Bureau of Labor Statistics

Monetary and fiscal policies don't seem to be helping employment. Since the start of the financial crisis, the Fed has lowered its key interest rate to effectively zero and the federal government has lowered tax rates and spent upwards of $1 trillion to stimulate the economy. "But we haven't seen in the data any kind of dramatic rebound in investments or buying of durable goods and housing," Waller said. "There is some spending, some hiring, some housing buys, but there seems to be a permanent drop in the level of consumption relative to the previous trend."

Households are retrenching. Consumption is lower partly because people have been deleveraging—restraining spending, reducing debt and repairing their balance sheets—over the past couple of years. "So, people are trying to get their debt down while we're encouraging them to spend—and it's not working like it has in the past," Waller noted.

Uncertainty weighs on most businesses. While some sectors, such as health care, continue to do well, overall hiring appears stuck. "We've asked businesses point-blank why they aren't hiring, even with very low interest rates and tax rates. They point to the lack of customers and the large uncertainty surrounding the health care laws, regulations and the political situation," Waller said.

The Labor Market Seems To Be Changing

Many businesses now treat layoffs as permanent job cuts instead of temporary decisions to be reversed when the economy improves. And while many businesses are posting vacancies, they aren't necessarily filling them.

Under normal economic conditions, vacancies are high when unemployment is low and vice versa. However, even though vacancies are coming back to pre-financial-crisis levels, unemployment remains high. This leads some economists to believe that some structural changes are happening in the labor market. (Please see "Many Moving Parts: A Look Inside the U.S. Labor Market" at www.stlouisfed.org/ar for details.)

As seen in the Figure at left, 42 percent of the unemployed have been out of work for at least six months, more than twice the percentage observed before the start of the financial crisis. "One study suggests that about half of the increase in long-term unemployment can be explained by demographic changes before the recession started, especially among older people," economist Kolesnikova said.

"Although unemployment rates are higher for younger workers, the rate is larger for all workers. Even people

with college degrees—regardless of their age—are unemployed at a higher rate now," she said.

Kolesnikova also noted that the market has become polarized between low-skill, low-pay jobs and high-skill, high-pay jobs; middle-skill, middle-pay jobs are disappearing. "For the past three decades, workers at midlevels have been replaced by computers, automation or jobs being sent overseas—a trend that has accelerated during this recession," she said.

Can the Fed Bring Down Unemployment?

In a survey from a previous "Dialogue with the Fed," 62 percent of audience members responded that the Fed could do little or nothing to bring the rate down. Waller agreed. "The Fed doesn't have much direct control over unemployment. We can use interest rates to help firms and help stimulate demand, but at the end of the day, we don't create any jobs; the private sector does. If they say no to our efforts, there is not much we can do about it," Waller said.

Even though the economy is flush with liquidity and the Fed has lowered the federal funds rate as far as it can go, some have called for more policy easing by suggesting the Fed aim for a specific unemployment rate. But that approach concerns policymakers and economists, including Waller, who are wary that the U.S. could enter a long period of high unemployment akin to what occurred in Europe during the 1980s and 1990s.

"We don't want to tie monetary policy to a specific unemployment number because we could end up stuck in that mode for decades," Waller explained.

In Sum: No Easy Solution To Ending High Unemployment

The Great Recession and its aftermath have not followed the historical patterns for recessions and recoveries: Unemployment has stayed around 9 percent for more than two years, the number of people out of work for more than six months is more than double pre-financial-crisis levels, and housing appears unable to lead the recovery. Economists are also seeing persistent changes in the labor market.

Although private payroll job growth stayed positive in 2010 and 2011, the growth appears inadequate to lower the high unemployment rate. Policymakers, lawmakers and economists have been debating the effectiveness of current monetary and fiscal policies designed to encourage spending and drive down unemployment.

›› MORE ONLINE

Construction and the Great Recession
www.stlouisfed.org/construction

Why Is Employment Growth So Low?
www.stlouisfed.org/lowgrowth

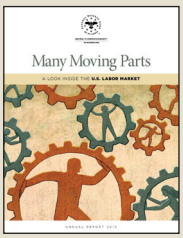
Have We Entered a "Jobless Recovery"?

After the 2001 recession, it was often said that increasing productivity helped produce a "jobless recovery," in which real per capita output rises while employment per capita remains steady or declines. To some, that seems to be happening again.

When asked at the Nov. 21 Dialogue whether "jobless recoveries" were real, economist David Andolfatto said that they were and noted what occurred during Canada's severe recession in the early 1990s. "It took seven to eight years for the unemployment rate to drop from 12 percent to below 8 percent. Employment just flatlined for a decade while GDP continued to rise. Eventually we came out of it," he said.

However, Andolfatto cautioned against reading too much into rising productivity, which has been occurring in most western developed economies for the last 100 to 150 years while employment per capita has remained fairly stable. "Rising productivity does not necessarily mean that employment levels will fall over the long run, according to the data."

Explore How the Labor Market Works



In any given month, tens of millions of people are on the move into, out of and inside the U.S. labor market. The St. Louis Fed's 2010 Annual Report, available online at **www.stlouisfed.org/ar**, explains how the labor market works. Unemployment and employment data are dissected by sex, level of education, type of work and more. The essay also examines how U.S. workers fared during the Great Recession compared with workers from other major countries.

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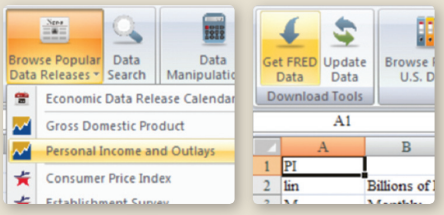

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Quarterly Report: Banking Conditions on the Upswing in District, Nation

Michelle Clark Neely

After stalling in the second quarter of 2011, bank earnings rebounded slightly in the third quarter, with both District and similar-sized U.S. banks recording increases in average profitability ratios. Return on average assets (ROA) jumped 10 basis points to 0.84 percent at District banks, up 27 basis points from a year ago. At U.S. peer banks—those with average assets of less than $15 billion—the increase in ROA was slightly smaller at 6 basis points; the third quarter ROA of 0.72 percent was 40 basis points higher than its level one year ago.

The rise in earnings at both sets of banks can be traced to improvements in the average net interest margin (NIM) and declines in loan loss provisions. At District banks, the average NIM increased 4 basis points to 4.02 percent and now stands 18 basis points above its year-ago level. For U.S. peer banks, the increase was also 4 basis points, with the NIM rising to 3.94 percent in the third quarter, a 7-basis-point gain from one year ago. At both sets of banks, the increase in average NIMs was due to increases in interest income and declines in interest expense.

Loan loss provisions continued their steady yearlong decline in the third quarter. For District banks, loan loss provisions as a percent of average assets fell 6 basis points to 0.53 percent. For U.S. peer banks, the loan loss provision ratio declined 2 basis points to 0.59 percent. The drop in loan loss provisions mirrors the mostly continual decline in nonperforming loans that has occurred since mid-2010.

Asset quality remains stable in the District and across the nation. At District banks, the ratio of problem assets (nonperforming loans and other real estate owned (OREO) to total loans plus OREO fell 6 basis points to 4.88 percent at the end of the third quarter. The decline in the problem assets ratio was more substantial for U.S. peer banks, at 18 basis points. At both sets of banks, most of the improvement in the aggregate ratio is related to the real estate loan portfolio, where the portion of nonperforming loans fell 9 basis points to 3.64 percent in the District and declined 20 basis points to 4.28 percent at U.S. peer banks. Although the drops in real estate loan delinquency rates were widespread at U.S. peer banks, not all categories of real estate loans at District banks experienced declines in nonperforming rates. Nonperforming loan rates for multifamily and nonfarm, nonresidential real estate loans rose in the third quarter in the District.

District banks had about 62 cents in reserves for every dollar of nonperforming loans at the end of the third quarter—unchanged from the second quarter and one cent more than at the same time a year ago. The loan loss coverage ratio at U.S. peer banks was slightly lower at 60 cents, up a penny from the second quarter and a nickel from a year ago.

District and U.S. peer banks remain, on average, well-capitalized. At the end of the third quarter, the average tier 1 leverage ratios for District banks and U.S. peer banks were 9.50 percent and 9.98 percent, respectively. Both ratios are up from their quarter-ago and year-ago levels.

On the Mend[1]

	2010: Q3	2011: Q2	2011: Q3
Return on Average Assets[2]			
District Banks	0.57%	0.74%	0.84%
U.S. Peer Banks	0.32%	0.66%	0.72%
Net Interest Margin			
District Banks	3.84%	3.98%	4.02%
U.S. Peer Banks	3.87%	3.90%	3.94%
Loan Loss Provision Ratio			
District Banks	0.82%	0.59%	0.53%
U.S. Peer Banks	1.06%	0.61%	0.59%
Problem Assets Ratio[3]			
District Banks	4.84%	4.94%	4.88%
U.S. Peer Banks	5.38%	5.13%	4.95%

SOURCE: Reports of Condition and Income for Insured Commercial Banks

1. Because all District banks but one have assets of less than $15 billion, banks larger than $15 billion have been excluded from the analysis.
2. All earnings ratios are annualized and use year-to-date average assets or average earning assets in the denominator.
3. Problem assets are loans 90 days or more past due or in nonaccrual status plus other real estate owned (OREO). The ratio is computed by dividing problem assets by total loans plus OREO.

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Statewide Bank Conditions for Third Quarter 2011[1]

Compiled by Daigo Gubo

	2010: Q3	2011: Q2	2011: Q3
Return on Average Assets[2]			
All Eighth District States	0.46%	0.59%	0.65%
Arkansas Banks	0.86	1.10	1.11
Illinois Banks	0.32	0.38	0.45
Indiana Banks	0.49	0.57	0.89
Kentucky Banks	0.92	0.87	0.83
Mississippi Banks	0.59	0.69	0.72
Missouri Banks	0.29	0.66	0.74
Tennessee Banks	0.21	0.22	0.14
Net Interest Margin			
All Eighth District States	3.76	3.85	3.89
Arkansas Banks	4.13	4.27	4.31
Illinois Banks	3.66	3.69	3.73
Indiana Banks	3.77	3.83	3.94
Kentucky Banks	4.04	4.17	4.12
Mississippi Banks	3.89	3.93	3.98
Missouri Banks	3.51	3.69	3.73
Tennessee Banks	3.79	3.86	3.89
Loan Loss Provision Ratio			
All Eighth District States	0.92	0.71	0.69
Arkansas Banks	0.72	0.52	0.50
Illinois Banks	1.19	0.96	0.93
Indiana Banks	0.90	0.66	0.47
Kentucky Banks	0.54	0.53	0.51
Mississippi Banks	0.82	0.60	0.56
Missouri Banks	0.86	0.53	0.56
Tennessee Banks	0.89	0.73	0.87
Nonperforming Loan Ratio[3]			
All Eighth District States	3.91	3.79	3.65
Arkansas Banks	3.27	4.01	3.78
Illinois Banks	5.12	5.07	4.78
Indiana Banks	3.13	3.03	3.14
Kentucky Banks	2.49	2.41	2.43
Mississippi Banks	3.13	2.80	2.70
Missouri Banks	3.98	2.99	2.99
Tennessee Banks	3.49	3.95	3.70
Nonperforming Loan + OREO Ratio[4]			
All Eighth District States	5.41	5.44	5.33

Arkansas Banks	5.05	6.09	5.83
Illinois Banks	6.55	6.76	6.55
Indiana Banks	3.80	3.80	3.89
Kentucky Banks	3.55	3.61	3.69
Mississippi Banks	4.56	4.56	4.50
Missouri Banks	6.01	4.74	4.80
Tennessee Banks	5.37	6.04	5.71

SOURCE: Reports of Condition and Income for Insured Commercial Banks.

NOTES:

1. Because all District banks except one have assets of less than $15 billion, banks larger than $15 billion have been excluded from the analysis.
2. All earnings ratios are annualized and use year-to-date average assets or average earning assets in the denominator.
3. Nonperforming loans are those 90 days or more past due or in nonaccrual status.
4. Nonperforming loans plus OREO are those 90 days past due or in nonaccrual status or other real estate owned.

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Banking and Economic Research

A Look at the Impact of the Financial Crisis and Recession on Banking Consolidation and Market Structure

Consolidations have long concerned community bankers, but the financial crisis and Great Recession made them even more wary of mergers and acquisitions.

Between Dec. 31, 2006, and Dec. 31, 2010, the number of U.S. commercial banks and savings institutions declined by 12 percent, continuing a consolidation trend begun in the mid-1980s. Banking industry consolidation has been marked by sharply higher shares of deposits held by the largest banks—the 10 largest banks now hold nearly 50 percent of total U.S. deposits.

To understand better how and why this is happening, bankers should read "The Impact of the Financial Crisis and Recession on Banking Consolidation and Market Structure" in the November/December *Review*. Dave Wheelock, vice president and deputy director of research at the St. Louis Fed, extends prior research on the structure of U.S. banking markets by investigating changes in deposit concentration at both the local and regional levels. He also examines the effects on local market concentration of mergers of banks operating in the same markets.

Is Shadow Banking Really Banking?

The term "shadow banking" describes a large segment of financial intermediation that is routed outside the balance sheets of regulated commercial banks and other depository institutions. Shadow banks are defined as financial intermediaries that conduct functions of banking without access to central bank liquidity or public sector credit guarantees.

The size of the shadow banking sector was close to $20 trillion at its peak and shrank to about $15 trillion in 2010, making it at least as big as, if not bigger than, the traditional banking system. Read more in *The Regional Economist's* primer, "Is Shadow Banking Really Banking?", which draws parallels between the shadow banking sector and the traditional banking sector.

The Gender Wage Gap May Be Much Smaller Than Most Think

The gap between earnings of male and female workers has declined significantly over the past 30 years, according to Bureau of Labor Statistics—but do the statistics tell the whole story?

The bureau reports that in 1979, median weekly earnings of full-time female workers were 63.5 percent of male workers' earnings, implying a gap of 36.5 percent. The earnings gap dropped to 30 percent in 1989 and to 23.7 percent in 1999. In the second quarter of 2011, the gap reached a low of 16.5 percent.

Despite the accuracy of these numbers, many researchers believe that the mere comparison of median weekly earnings of male and female workers presents an incomplete picture. Find out more with St. Louis Fed economist Natalia Kolesnikova and research associate Yang Liu, who investigate how “The Gender Wage Gap May Be Much Smaller Than Most Think” in the October 2011 *Regional Economist*.

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Rules and Regulations

Out for Comment: Proposed "Volcker Rule" in the Dodd-Frank Act

What potential impacts could the proposed "Volcker Rule" have on banking entities? The Volcker Rule requirements are part of the Dodd-Frank Act's Section 619, which contains general prohibitions and restrictions on the ability of banking entities and nonbank financial companies to engage in proprietary trading as well as have certain interests in, or relationships with, a hedge fund or private equity fund.

The Volcker Rule proposal (developed jointly by the Fed, the FDIC, the Office of the Comptroller of the Currency, the Securities and Exchange Commission and the Commodity Futures Trading Commission), clarifies the scope of the Dodd-Frank Act's prohibitions and provides certain exemptions to these prohibitions. See details in the Fed's press release, and enter your comments in the official record by Feb. 12, 2012.

Out for Comment: Help the CFPB Set Regulatory Priorities

Which regulatory provisions should the new Consumer Financial Protection Bureau (CFPB) tackle first?

You can help the bureau determine its top priorities for updating, modifying or eliminating the existing federal consumer financial regulations that came under the CFPB's authority in July 2011. The regulations transferred from seven other agencies, and the bureau wants to change or end rules that are found to be outdated, unduly burdensome or unnecessary.

Until changes can be made to the existing regulations, the CFPB is republishing them as interim final rules to reflect the transfer of authority, but not to impose any new substantive obligations. See more in the "Interim Final Rules" section of our Dodd-Frank Regulatory Reform Rules web site.

The agency welcomes your comments on the consumer financial regulations by March 5, 2012.

Agencies Clarify Supervision, Enforcement Responsibilities for Federal Consumer Financial Laws

Five regulatory agencies explained in November that they would use the June 30, 2011, Call Reports to decide an institution's supervisor for federal consumer financial laws.

The Federal Reserve, FDIC, Office of the Comptroller of the Currency (OCC), the National Credit Union Association (NCUA) and the new Consumer Financial Protection Bureau (CFPB) agreed to determine the total asset size of an insured bank, thrift or credit union based on that specific Call Reports release. (The agencies chose the release closest to when the CFPB began operations on July 21, 2011.)

As called for by the Dodd-Frank Act, the CFPB has exclusive authority to examine and primary authority to enforce federal consumer financial laws for institutions with total assets of more than $10 billion, as well as

their affiliates. The Fed, FDIC, OOC and NCUA retain their respective supervisory and enforcement authority for the remaining institutions with total assets of $10 billion and under.

To avoid unwarranted uncertainty or volatility, the agencies generally won't change an institution's initial classification unless four consecutive quarterly reports indicate that a supervisory change is in order.

Certain Financial Companies Are Now Required to Submit Resolution Plans

Federal agencies hope that new regulations will help avoid harm to the financial system if a large, systemically significant bank holding company (BHC) or nonbank financial company fails.

Such companies are now required to submit annual resolution plans, also called living wills, to the Federal Reserve and the FDIC. The Dodd-Frank Act mandated creating living wills to ensure the rapid and orderly resolution of such companies if they experience material financial distress or failure. In addition to the plan requirements, the final rule details the procedures and standards that the Fed's Board of Governors and FDIC will use to review resolution plans.

If you commented on the proposed version of the rule between April and June 2011, note that the final rule (effective Nov. 30, 2011) does not include the requirement for the submission of quarterly credit exposure reports. Instead, the Board and FDIC will coordinate development of those reports in conjunction with the Dodd-Frank Act's single counterparty credit exposure limits.

A related final rule issued by the Federal Reserve requires BHCs with total consolidated assets of $50 billion or more to submit annual capital plans as well as obtain prior approval for certain capital distributions. The rule, effective Dec. 30, 2011, is encompassed in amendments to Regulation Y.