President's Message

"If we never want to go through what Japan has experienced, the first principle we have to accept is that deflation is difficult to forecast. No one in Japan saw it coming, nor did economists elsewhere—even Fed economists."

William Poole

PRESIDENT AND CEO,
FEDERAL RESERVE BANK OF ST. LOUIS

Lessons from Japan

Now that Japan's economy finally seems to have turned the corner, we can sit back, exhale and consider what we might learn from its slow-motion meltdown over the past 13 years.

Why should we study Japan's troubles? The size of its economy is second or third (different measures yield different rankings) only to ours, and we've often traveled the same paths.

The worst effect of Japan's meltdown was asset-price deflation, with equity prices declining sharply in early 1990 and land prices beginning their long decline in 1991. Deflation in the price of goods started in 1995. Although consumer prices reversed course for a while, they declined in each of the past four years. The falling prices deterred spending by consumers and businesses; they were reluctant to buy because they figured prices would continue to go lower and lower.

Many armchair economists feared that the U.S. economy would follow the same scenario. But deflation didn't visit our shores. Still, our economy had been flat for most of the past three years, only recently picking up steam.

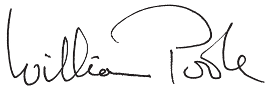
If we never want to go through what Japan has experienced, the first principle we have to accept is that deflation is difficult to forecast. No one in Japan saw it coming, nor did economists elsewhere—even Fed economists.

Second, when deflation hits, easing of monetary policy often isn't enough. The trick is to stop deflation before it gets started by lowering interest rates aggressively and quickly to get people buying again. The Japanese thought they were easing monetary policy in the early 1990s, but they didn't go far enough fast enough—the same sort of hesitation that worsened our own Great Depression. Although interest rates were coming down in Japan, the central bank there was actually holding them up relative to the level required to maintain the economy's stock of liquidity.

Third, Japan showed us that a central bank has more than one tool to work with. Many thought Japan had run out of firepower when it took that one tool—short-term interest rates—down to zero and the economy still didn't respond. But finally, the Bank of Japan implemented a monetary policy focused on quantitative easing. That policy forced liquidity into the economy, and now economic activity is finally starting to recover.

Japan's problems are deeper than just monetary policy. Problems continue in the banking system, and numerous structural rigidities beset the economy. In contrast, our banks are strong (healthy capital ratios and record profits this year), and flexibility is a key feature of our economy. For example, we have workers willing to move across the country to get a job. Japan doesn't. We're quick to react to changes, in general. They're slow and methodical.

For these and other reasons, what happened in Japan isn't likely to happen here. But we should never say never, especially in view of Japan's being our role model—everybody's role model—as recently as the 1980s.

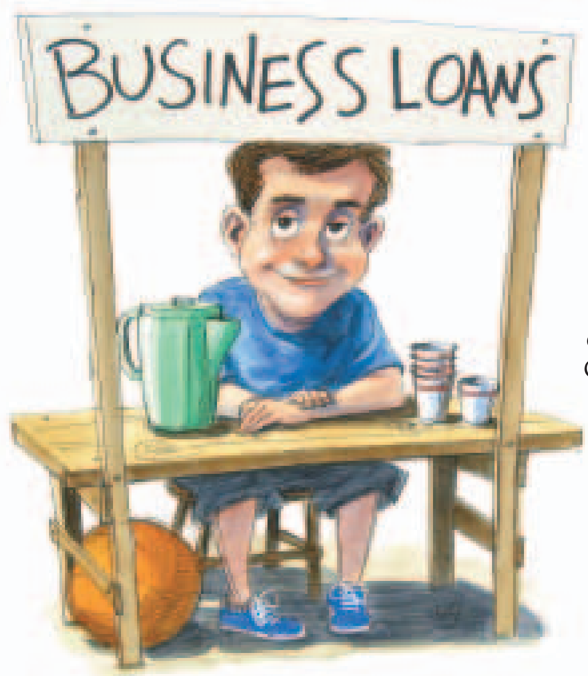


CREDIT UNIONS MAKE FRIENDS— But Not with Bankers

By William R. Emmons and Frank A. Schmid

Despite the rather low profile and mundane operations of the vast majority of credit unions, these institutions have long been a source of controversy in the United States, primarily in the banking community. For decades, bankers have objected to the tax breaks and sponsor subsidies enjoyed by credit unions and not available to banks. Because such challenges haven't slowed down the growth of credit unions, banks continue to look for other reasons to allege unfair competition.

Public awareness of the long-simmering credit-union debate was piqued about five years ago by a Supreme Court case pitting commercial banks against credit unions and their federal regulator.[1] The court found in favor of banks and their trade association, ruling that the regulator of federal credit unions, the National Credit Union Administration (NCUA), must not allow them to expand by combining more than one field of membership, or common bond among members. In other words, the Supreme Court ruled that each credit union should remain focused on a single membership group—employees of a company, members of a fraternal or religious organization, or residents of a neighborhood, to cite a few examples. Less than six months later, however, President Bill Clinton signed into law new legislation that essentially reversed the Supreme Court's ruling. Thus, credit unions now may expand by merging multiple (unrelated) fields of membership.



But the feud continues. The American Bankers Association (ABA) sued the NCUA in 1999, alleging that the NCUA violated the intent of Congress in implementing the new credit-union legislation. The ABA's complaint was dismissed by a U.S. Appeals Court in late 2001. Still, the ABA continues to document and comment on all sorts of issues related to credit unions.[2]

CREDIT UNIONS have been allowed to increase the amount of business lending they do; this frustrates bankers, who believe that credit unions should focus on households.

Most of the bankers' attacks are waged on three fronts. First, bankers believe it is unfair that credit unions are exempt from federal taxation while the taxes that banks pay represent a significant fraction of their earnings—33 percent last year. Second, bankers believe that credit unions have been allowed to expand far beyond their original purpose. The third major battleground concerns how credit unions are regulated and the financial services they are allowed to offer. For example, banks are subject to the Community Reinvestment Act (CRA), which requires banks to make specified amounts of loans in the communities in which they take deposits. Credit unions are exempt from the CRA. As for the services, credit unions have been allowed to increase the amount of business lending they do; this frustrates bankers, who believe that credit unions should focus on households.

Credit Unions Today

Credit unions are regulated and insured financial institutions dedicated to the saving, credit and other basic financial needs of selected groups of consumers. By law, credit unions are cooperative enterprises controlled by their members under the principle of "one person, one vote." In addition, credit union members must be united by a "common bond of occupation or association, or [belong] to groups within a well-defined neighborhood, community, or rural district," according to the Federal Credit Union Act of 1934.

Credit unions numbered 10,041 at the end of last year, serving more than 80 million members. At the same time, there were 7,887 FDIC-insured commercial banks and 1,534 insured thrift institutions (savings and loan associations and mutual savings banks). Most credit unions are very small, though: Credit-union assets totaled $575 billion, compared to $7,075 billion held by commercial banks and $1,359 billion held by thrifts.[3]

The deposits (or, technically, "shares") of virtually all credit unions are now federally insured by the NCUA, regardless of the type of charter they hold. Federal credit unions are regulated by the NCUA, while state-chartered credit unions are regulated by an agency of the chartering state.

Every credit union is organized around a field or fields of membership shared by the members. A field of membership can consist of any one of the following:

- a single group of individuals who share a common bond;
- more than one group, each of which consists of individuals sharing a common bond (not necessarily the same type in each group); or
- a geographical community.

Common bonds are either occupational (the employees of a firm), associational (members of an association, such as a religious or fraternal organization) or geographical (all individuals who live, work, attend school or worship within a defined community).[4]

By size, most credit unions (57 percent of federally insured institutions) had less than $10 million in assets in mid-2000. Large credit unions exist, however, and they are an important part of the sector. For example, the 15 percent of credit unions with more than $50 million in assets (1,554 institutions) accounted for 79 percent of total credit-union assets.[5]

Credit unions play a limited role in the U.S. financial system. More than 95 percent of all federal credit unions offer automobile and unsecured personal loans. A similar proportion of large credit unions (more than $50 million in assets) also offer mortgages; credit cards; loans to purchase planes, boats or recreational vehicles; ATM access; certificates of deposit; and personal checking accounts.[6] Only about 14 percent of credit unions have business loans outstanding.[7]

Very small credit unions typically offer a limited range of services, rely on members to volunteer as staff and are likely to receive free or sponsor-subsidized office space. Sometimes, one or more firms (not necessarily in the same industry) may sponsor an occupational credit union, providing office space, paid time off for volunteer workers and perhaps other forms of support as a fringe benefit to employees. Larger credit unions offer a broader array of services, may employ some full-time workers (including the manager) and are more likely to pay a market-based rent for office space.

Historically, members of credit unions were drawn from groups that were underserved by traditional private financial institutions; these consumers tended to have below-average incomes or were otherwise not sought out by banks. Today, the demographic characteristics of credit union members have become more like those of the median American. In fact, current members are over-represented by the upper middle-income strata, defined as household incomes between $30,000 and $80,000 in 1987.

Here are a few more numbers about credit unions:

• Only 1 percent of the U.S. adult population aged 18 or over belonged to a credit union in 1935, but about 38 percent of the adult population had joined by 2001.

• According to a 1987 credit-union survey, 79 percent of all Americans who were eligible to join a credit union had done so.[8]

• Given the prominent role of occupational credit unions, a majority of members of all credit unions are in the prime working ages of 25-44.

Overall, it appears that credit unions, banks and thrifts are more direct competitors today than when credit unions first appeared.[9]

Legislative History

The predecessors of American credit unions were cooperative banking institutions of various sorts in Canada and Europe in the 19th century. The first credit union in the United States was formed in Manchester, N.H., in 1909.[10] Soon thereafter, Massachusetts created a charter for credit unions. From there, the credit-union movement swept across the United States, meeting with particular success in the New England and upper Midwestern states.

These early cooperative financial institutions often had a social, political or religious character in addition to their explicit economic function. While the social and political aspects of the cooperative movement were acknowledged and accepted by Congress, the Federal Credit Union Act (FCUA) of 1934 was focused more narrowly on the economic potential of credit unions.

The legislation itself was modeled closely on state credit-union statutes that had appeared in the early decades of the 20th century in the Northeast and upper Midwestern states. The FCUA clearly reflected congressional intent to create a class of federally chartered financial institutions that would operate in a safe and sound manner:

> *… the ability of credit unions to "come through the depression without failures, when banks have failed so notably, is a tribute to the worth of cooperative credit and indicates clearly the great potential value of rapid national credit union extension."* (Supreme Court, 1998, p. 17, citing the FCUA)

The likelihood that federal credit unions would serve consumers not served by banks was an additional element in congressional deliberations:

> *Credit unions were believed to enable the general public, which had been largely ignored by banks, to obtain credit at reasonable rates.* (Supreme Court, 1998, p. 17)

Credit unions are exempt from federal taxation because Congress views them as "true" member cooperatives and, therefore, quite different from banks and thrifts. The major benefit of tax exemption is that credit unions can retain earnings tax-free. Advocates argue that this is justified because credit unions cannot raise equity in a public offering; so, they must be able to build capital internally. Opponents believe this is an unfair subsidy.

It is clear from the legislative history surrounding the passage of the FCUA in 1934 that Congress saw the common-bond requirement as critical to the success of credit unions. The common-bond requirement:

> *… was seen as the cement that united credit union members in a cooperative venture, and was, therefore, thought important to credit unions' continued success. …Congress assumed implicitly that a common bond amongst members would ensure both that those making lending decisions would know more about applicants and that borrowers would be more reluctant to default.* (Supreme Court, 1998, pp. 17-18)

1998 Act Made Expansion Easier for Credit Unions

PRESIDENT BILL CLINTON SIGNED THE CREDIT UNION MEMBERSHIP ACCESS ACT ON AUG. 7, 1998, FOLLOWING APPROVAL IN THE SENATE ON JULY 28 AND IN THE HOUSE ON AUG. 4. The act substantially reverses a Supreme Court ruling handed down on Feb. 25, 1998, that would have barred federally chartered credit unions from accepting multiple membership groups, each with its own common bond. This landmark credit-union legislation represented a major defeat for the top lobbying group representing commercial banks, which had argued successfully at the Supreme Court that credit unions with multiple common bonds violated both the letter and the spirit of federal legislation dating from 1934. The subsequent legislative response in support of multiple common bonds at credit unions was swift and overwhelming, passing both chambers with large majorities.

The 1998 act contains three provisions upholding the rights of federal credit unions to serve membership groups encompassing multiple common bonds. First, all federal credit unions that already included multiple common bonds before Feb. 25, 1998, were allowed to continue operating without interruption. Second, all federal credit unions were given the right to accept additional membership groups with multiple common bonds so long as the group to be acquired had fewer than 3,000 members. Third, the act gives the National Credit Union Administration the right to grant exemptions to the 3,000-member limit under certain circumstances, such as when the group in question could not reasonably support its own credit union.

The act also:

- requires annual independent audits for insured credit unions with total assets of $500 million or more,
- authorizes and clarifies a federally insured credit union's right to convert to a mutual savings bank or savings association without prior NCUA approval,
- limits business loans to members to 12.25 percent of total assets,[12]
- establishes new capital standards for insured credit unions similar to those enacted for banks and thrifts in 1991,
- gives the NCUA authority to base deposit-insurance premiums on the reserve ratio of the insurance fund and
- directs the Treasury to report to Congress on differences between credit unions and other federally insured financial institutions, including the potential effects of applying federal laws—including tax laws—to credit unions. (This report is listed in the references as U.S. Treasury, 2001a.)

Hailing the new legislation, Clinton said, "This bill ensures that consumers continue to have a broad array of choices in financial services….and [makes] it easier for credit unions to expand where appropriate." Meanwhile, a spokeswoman for the American Bankers Association termed it "ironic" that the bill was presented as a measure to protect credit unions because in the long run, she said, it will dilute them, turning them into larger and larger institutions.[13]

The subsequent history of credit unions in the United States largely has fulfilled the promise envisioned by Congress in 1934. Credit unions have grown and spread across the country. Although hundreds of individual credit unions failed during the 1980s and early 1990s, the National Credit Union Share Insurance Fund (NCUSIF, formed in 1970) avoided accounting insolvency—in marked contrast to the Federal Savings and Loan Insurance Corp. and the Bank Insurance Fund of the Federal Deposit Insurance Corp.[11]

The State of the Debate

The special status and comparative success of credit unions in recent decades, coinciding as it has with a period of stress on thrift and commercial-banking institutions, has led to political conflicts between advocates of credit unions and banks. This conflict reached its high point in a series of court decisions culminating at the U.S. Supreme Court in October 1997. The particular case at issue involved the AT&T Family Credit Union and the NCUA's interpretation of the 1934 FCUA allowing multiple common bonds of membership. Brought by several banks and the American Bankers Association, the case was ultimately decided in February 1998 (on a 5-4 decision) in favor of the banks that had sued to stop the NCUA from granting more multiple-group credit-union charters. The bankers' victory was short-lived, however, as Congress almost immediately drafted new legislation that enabled credit unions to continue growing much as before—including multiple common bonds within a single credit union. (The sidebar summarizes the key provisions of the act.)

Attacks on credit unions have stemmed from a wide range of viewpoints, including sometimes contradictory arguments. Some of the arguments used in the 1998 Supreme Court decision concerning the role of the common-bond requirement in credit unions reflect the unsettled nature of the debate. There are two main theoretical strands in the credit-union debate—one argument that stresses inefficient governance structures and another that stresses "unfair competition."

Some have argued that credit unions are inherently inefficient because of their one-member, one-vote governance structure. One might expect decision-making in a credit union to be of poor quality because of a lack of professionalism (i.e., volunteer managers and workers), members' lack of interest in monitoring management, and weak incentives for members to intervene when action is needed to correct specific problems or deficiencies. According to this argument, credit unions may waste scarce economic resources and they may eventually impose significant costs on individual sponsoring firms or the economy as a whole.

The second prominent line of argument aimed at credit unions takes a nearly opposite view of their organizational effectiveness. This view presumes that credit unions operate efficiently enough to offer consistently better terms on savings and credit services than those offered by commercial banks and thrifts. Managers and owners of banks and thrifts often present this point of view in public discourse. To be sure, those arguing that credit unions represent unfair competition ascribe some or all of their competitive advantages to their tax-exempt status or to subsidies from sponsors rather than inherent efficiency.

Proponents of the first view—that credit unions are inherently inefficient—have a difficult time explaining why the number of credit unions and credit-union members continues to grow and why members express high levels of satisfaction with the services they receive. If most credit unions were very inefficient, one might expect their members to become disaffected and their role in the financial system to diminish over time.

On the other hand, proponents of the second view—that credit unions are unfair competitors due in part to tax exemption and sponsor subsidies—cannot explain easily why credit-union sponsors and governments are such strong supporters of credit unions. It is hard to understand why large net benefits or subsidies would be delivered to credit-union members indefinitely. Wouldn't we expect more opposition arising from constituencies that might be paying the subsidies, such as sponsors' shareholders or employees who do not belong to their firm's occupational credit union, or taxpayers who belong to no credit union at all? In fact, the most vocal complaints about subsidies for credit unions are heard from banks and thrifts, whose resentment of credit-union competition is hardly surprising. At the same time, banks and thrifts receive publicly provided benefits such as deposit insurance and entry restrictions.

Interestingly, both of these lines of attack against credit unions appeared in the argumentation of the Supreme Court majority that decided the AT&T Family Credit Union case in favor of commercial banks. At one point in its opinion, the majority cited the legislative history surrounding the 1934 Federal Credit Union Act as support for the view that credit unions are a fragile—even flawed—type of institution, reasoning that:

> *Because, by its very nature, a cooperative institution must serve a limited market, the legislative history of Section 109 demonstrates that one of the interests "arguably…to be protected" by Section 109 is an interest in limiting the markets that federal credit unions can serve.* (Supreme Court, 1998, footnote 6, pp. 8-9)

Thus, a credit union would become inefficient if it grew beyond its "limited market," as defined by its common bond.

At a different point in its opinion, however, the majority accepted the argument that credit unions with multiple groups of members would be *more* formidable competitors to banks and thrifts than single-group institutions were. The majority argued that an expansive interpretation of the 1934 act "would allow the chartering of a conglomerate credit union whose members included the employees of every company in the United States." In other words, credit unions would overwhelm banks and thrifts unless otherwise constrained.

The Future of the Debate

The irony inherent in the Supreme Court's majority opinion, of course, is that the court's extreme example of a hypothetical "conglomerate credit union" flies in the face both of its earlier reasoning and the legislative history of the 1934 act. The credit-union debate of 70 years ago, after all, had essentially predicted that such a huge credit union would not have been a safe and sound financial institution, nor consequently a viable one in the long run.

Thus, the long-running credit-union debate shows no signs of ending. The actors and the arguments may change, but the survival of credit unions in one form or another does not appear in doubt.

William R. Emmons is an economist in the Banking Supervision and Regulation Division, and Frank A. Schmid is a senior economist in the Research Division, both at the Federal Reserve Bank of St. Louis.

ENDNOTES

1 Supreme Court, 1998.

2 The American Bankers Association web site provides a great deal of information about credit unions and why banks believe credit unions' regulatory and tax treatment should change. www.aba.com/Industry+Issues/Issues_CU_Menu.htm.

3 4,091 credit unions had state charters while 5,950 had federal charters. Credit Union National Association, 2003. www.cuna.org/download/us_totals.pdf. The data for commercial banks and thrift institutions are from the FDIC. www.fdic.gov/bank/statistical/stats/2002dec/industry.pdf.

4 U.S. Treasury, 2001a.

5 U.S. Treasury, 2001a.

6 U.S. Treasury, 1997.

7 U.S. Treasury, 2001b.

8 American Bankers Association, 1989.

9 A recent study found a tangible impact of credit unions on the deposit rates offered by banks and thrifts (Hannan, 2003).

10 U.S. Treasury, 1997.

11 Kane and Hendershott, 1996.

12 A Treasury Department study describes current credit-union business lending activity (U.S. Treasury, 2001b).

13 *BNA Banking Report*, 1998.

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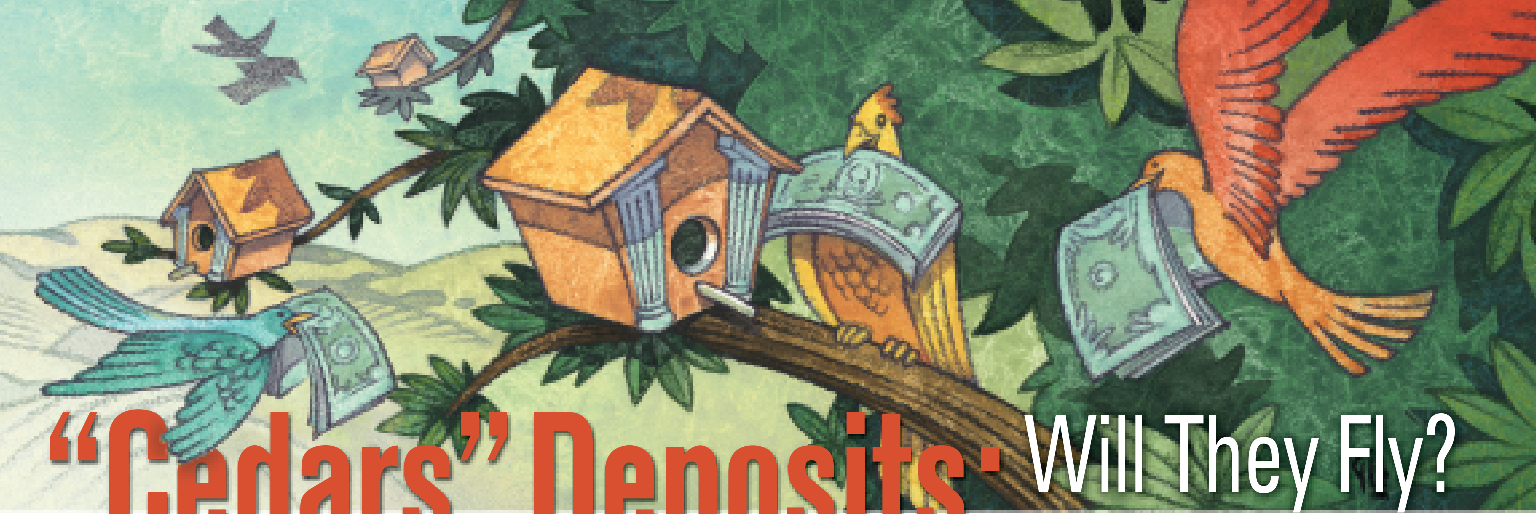

“Cedars” Deposits: Will They Fly?

By Mark D. Vaughan and Timothy J. Yeager

CDARS—pronounced “cedars”—is the newest funding tool used by deposit-hungry community banks. CDARS stands for “Certificate of Deposit Account Registry Service.” Through this service, small and medium banks can offer their customers insurance on deposits greater than $100,000—the usual maximum to be insured—because the excess is placed with other banks.

CDARS is the sole service of Promontory Interfinancial Network, a bank consulting firm based in Washington, D.C., that is led by Eugene Ludwig, former comptroller of the currency, and Alan Blinder, former vice chairman of the Federal Reserve System’s Board of Governors. The service made its debut in January 2003. As of August, about 350 banks belonged to the Promontory network, and about half of those actively used CDARS. Over the long run, CDARS may help community banks compete for large-deposit customers. In the short run, CDARS will complicate the lives of bank supervisors.

Growing CDs with CDARS

Until recently, community banks have struggled to raise the funds necessary to cover loan growth. The long, robust expansion of the 1990s enabled community banks to book new loans at a brisk pace. At the same time, financial innovation generated a host of new investment vehicles to compete with deposits. As a consequence, the loan-to-deposit ratio at U.S. community banks rose sharply.[1] At year-end 1992, the aggregate ratio was 61.3 percent, meaning there was 61 cents in loans for every $1 in deposits in U.S. community banks. By year-end 2002, that ratio stood at 76.5 percent.[2]

Community bankers face stiff competition for deposits from credit unions and large banks. Credit unions enjoy tax-exempt status, which gives them a competitive edge in setting yields on deposits. Meanwhile, many jumbo depositors at large banks figure these banks still enjoy “too big to fail” status, which effectively would insure all deposits against losses. In addition, if depositors do have concerns about potential losses, large multibank holding companies can spread the jumbo deposits (those over $100,000) among their own bank subsidiaries to provide 100 percent insurance coverage. Community bankers argue that the playing field would be somewhat leveled if the coverage ceiling for deposits were raised from its current $100,000 level, but Congress has been unwilling to do so thus far.[3]

CDARS may help to fill a funding gap by attracting local and otherwise uninsured funds back to community banks. With CDARS, a community bank can spread large deposits across other institutions in the Promontory network in chunks under the $100,000 insured threshold. At the same time, an equal amount of funds from these other network institutions are placed in the initiating bank. So, each bank ends up with the same amount of deposits brought in by its customers, but the entire balance in each bank is insured instead of just the original portion under $100,000.

This deposit-insurance swap could benefit community banks by helping them attract and retain funds from customers who demand complete insulation from losses, customers such as retirees and local governments. But there is a price, of course. Promontory levies an “on-boarding” fee that varies with bank size, a transaction fee that varies with the maturity of the deposit swap and a quarterly account minimum fee, which is levied on members that fail to generate a minimum number of CDARS transactions. Included in the price of CDARS is all the attendant legal paperwork. This paperwork includes the consumer documentation required by bank disclosure laws, the 1099s reporting taxable interest required by the IRS and the contracts settling interest differentials among network banks with different jumbo-CD yields.

A Regulatory Perspective

At first glance, CDARS might raise some regulatory eyebrows. Funds placed in the Promontory network are immediately classified as brokered deposits on the reports that banks must file quarterly with their supervisory agency. Traditionally, the term “brokered deposits” has been applied to funds pooled in blocks just under $100,000 by securities broker-dealers and then placed in depository institutions offering the highest yield. In the thrift crisis of the 1980s, many insolvent institutions paid dearly for brokered deposits and then used them to make risky loans. These institutions, with one foot in the grave, did not care about the cost of brokered deposits because they were gambling on resurrection. The post-crisis reforms in federal banking laws restricted the use of brokered deposits by banks and thrifts with low net worth. Even for well-capitalized institutions, supervisors closely monitor dependence on brokered deposits because such funds have historically been considered “hot money”—that is, they could flee upon maturity at the slightest promise of a better yield, precipitating a funding crunch.[4]

CDARS are not likely to cause the problems that brokered deposits did during the thrift crisis. As noted, bank supervisors now have procedures in place to monitor the use of brokered deposits and prevent their misuse. Even more important, the CDARS deposit swap is generally initiated by a desire to retain local deposits, not by a desire to cover potentially unsafe-and-unsound loan growth. Moreover, any bank bent on acquiring funds to cover imprudent growth would find it much easier to sell jumbo deposits in the wholesale-funding market. Banks willing to pay the going rate can typically get all the wholesale jumbos they need. And wholesale jumbos would not have to be swapped with deposits from other banks, as is necessary with CDARS.

Any new funding instrument must also be judged on the moral hazard introduced to the deposit insurance fund. With CDARS, otherwise uninsured jumbo CDs placed into the network become insured. And because covered depositors are shielded from losses, FDIC insurance weakens depositors' incentives to monitor a bank's financial condition. Depositors are less likely to withdraw funding or demand higher interest rates as banks increase their risk; so, deposit insurance implicitly encourages risk-taking by allowing bankers to escape the full price of their behavior.

Recent research, however, suggests that jumbo-CD holders are not particularly sensitive to bank risk—at least in the current institutional and economic environment.[5] Because of deposit-preference laws—which give domestic jumbo-CD holders priority over foreign depositors in failure resolutions—and high bank-capital levels, expected losses on jumbo CDs are small. Therefore, little monitoring or disciplining by uninsured depositors is going on. Put simply, weakening already weak depositor discipline by transforming jumbo CDs into fully insured CDs should not exacerbate moral hazard.

But institutional and economic environments change; so, it is possible that CDARs could cause moral-hazard problems down the road. Evaluating the social losses from such a problem requires consideration of other policy alternatives on the table. For the past year, Congress has toyed with raising the deposit-insurance ceiling to $130,000 from $100,000. How would an implicit hike in the coverage ceiling arising from extensive use of CDARs compare with an explicit hike of $30,000 arising from congressional action?

Answering this question requires identifying the banks most likely to join the Promontory network. The most likely joiners are smaller, community-focused banks with relatively weak deposit bases—that is, institutions that hold less than $1 billion in assets, that do not belong to multibank holding companies and that fund growth with brokered deposits or Federal Home Loan Bank advances.[6] Other likely joiners are recently chartered banks *(de novos)*. If all such institutions joined Promontory, and every dollar of uninsured deposits on their balance sheets entered the CDARs network, then the liabilities of the FDIC would rise by about $38 billion. This figure is about 14 percent of the increase that would occur if the deposit-insurance ceiling were raised to $130,000 from $100,000. So, CDARS could be viewed as a less costly alternative to raising the ceiling.[7]

CDARS and Surveillance

CDARs could cause a short-run supervisory headache by significantly distorting ratios used in off-site surveillance. In bank supervision, off-site surveillance refers to the use of accounting data and anecdotal evidence to schedule on-site examinations and to monitor bank progress in addressing previously identified deficiencies. As noted, heavy dependence on brokered deposits has traditionally been a supervisory red flag. And, as also noted, funds placed in the Promontory network are automatically reclassified as brokered deposits on bank financial statements. Therefore, banks making use of CDARs could end up attracting unwarranted supervisory attention.

To see the problem, consider a representative balance sheet for the most likely joiners of the Promontory network. On this balance sheet, the brokered deposit to total deposit ratio is about 8 percent. If all uninsured deposits are put in the network, then the ratio of brokered deposits to total deposits ratio would soar to 36 percent. This latter ratio ranks in the 99th percentile for U.S. commercial banks. In the coming quarters, as more banks join Promontory, bank supervisors will have to watch brokered-deposit ratios carefully and follow up with "red-flagged" banks to identify the active CDARs users. Only such follow-up can prevent unnecessary supervisory intervention.

Conclusion

Of course, the full supervisory implications of CDARs will not be clear until evidence is available about how banks have reshaped their balance sheets in response to the product. And, community bank depositors may not respond as enthusiastically as expected to deposit protection afforded by CDARs—so this may end up as much ado about nothing. Still, securing the funding necessary to compete effectively with large banks and credit unions remains a continuing challenge for community bankers. CDARs could end up as an important new tool for meeting this challenge.

Mark D. Vaughan is the supervisory policy officer and Timothy J. Yeager is an economist and senior manager in the Banking Supervision Division of the Federal Reserve Bank of St. Louis.

ENDNOTES

1. For data-analysis purposes, we define a community bank as an institution holding less than $500 million in assets—the definition set forth for regulatory purposes in the Financial Modernization Act of 1999.
2. For a discussion of the funding challenges faced by U.S. commercial banks, see Stackhouse and Vaughan (2003).
3. For a discussion of the pros and cons of raising the deposit insurance ceiling, see Vaughan and Wheelock (2002).
4. For a discussion of the role of brokered deposits in the thrift crisis, see White (1991).
5. For recent evidence about monitoring and disciplining by the jumbo-CD market, see Hall, King, Meyer and Vaughan (2002).
6. For a discussion of the importance of Federal Home Loan Bank funding to community banks, see Stojanovic, Vaughan and Yeager (2000).
7. These figures are "back-of-the envelope" estimates based on Congressional Budget Office analysis (CBO 2002) and the authors' calculations. The actual numbers will vary because not all uninsured deposits will enter the Promontory network, and participating banks will reshape their balance sheets in response to the availability of CDARS.

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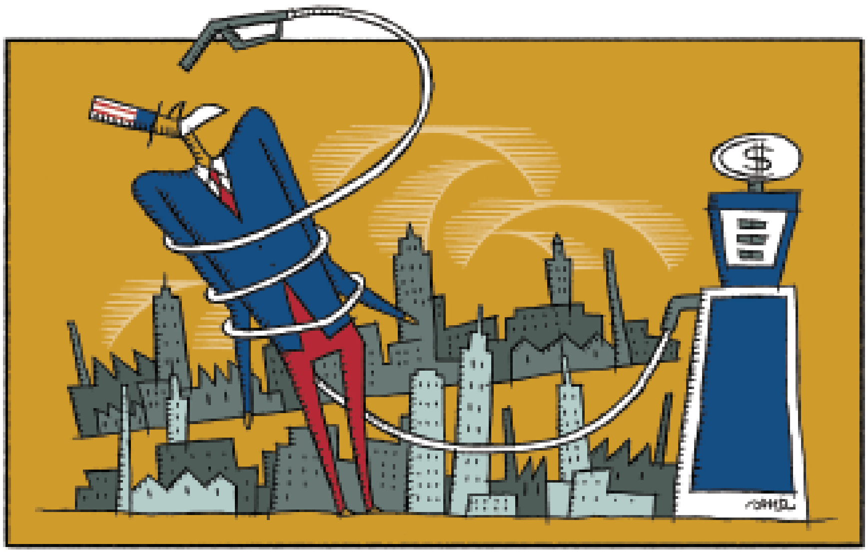


Does Uncertainty about Oil Prices **Slow Down** the Economy?

By Richard G. Anderson and Michelle T. Meisch

The correlation between increases in the price of oil and downturns in U.S. economic activity is one of the most-studied relationships in macroeconomics. In the January 2001 issue of *The Regional Economist,* Kevin Kliesen noted that a sharp increase in the price of oil has preceded each economic downturn since World War II.[1] When oil prices increased sharply during late 2002, some analysts feared a repeat of this pattern—and, indeed, real GDP increased during the fourth quarter of 2002 and the first quarter of 2003 at a 1.5 percent rate, less than half its 4.0 percent rate during the third quarter of 2002.[2]

Oil Prices and the Economy

Many goods purchased by consumers and businesses—including motor vehicles, residential and nonresidential structures, and industrial machinery—will use a significant amount of oil-based products during their lifetimes. A jump in the price of oil today doesn't have much impact on the economy if users are convinced that the increase is going to be short-lived. It's the uncertainty regarding *future* oil prices that takes a toll. Such uncertainty induces consumers and businesses to delay purchases of these big-ticket goods until the future price situation becomes clearer.[3]

Market analysts and policy-makers infer changes in uncertainty regarding future oil prices from many sources of information, including expert opinion, international political events, changes in the prices of oil futures contracts and previous episodes in which oil prices increased significantly. We review each of these.

Does Expert Opinion Matter?

Prior to the U.S. invasion of Iraq, crude oil prices increased by more than 45 percent between December 2002 and February 2003, ending February at nearly $40 per barrel, including a "war premium" of $5 to $15 per barrel. Besides the threat of war, other events drove up prices. Political disruptions in Venezuela caused its oil production to fall by 90 percent. Violence in Nigeria threatened its oil fields. Worldwide demand was unusually high because of a variety of events, including Tokyo Electric Power's shutting down 13 of its 17 nuclear reactors and unusually cold weather in the United States. Inventories, which were at their lowest level since 1975, could not cushion the demand surge. Uncertainty regarding the size of future price increases was widespread; some analysts predicted that near-term crude oil prices would top $50 per barrel.

The uncertainty induced by contemporary political events was probably reinforced by published expert analyses. Typical was a report from the Center for Strategic and International Studies, widely reported during March 2003, that discussed four scenarios.[4] In the "No War" scenario, Saddam disarms or is replaced in an internal coup and oil prices average $24 in 2003 and $18 in 2004. In the "Benign" scenario, Iraqi oil fields are undamaged by war and oil prices average $26 in 2003 and $22 in 2004. In the "Intermediate" scenario, sabotage and guerrilla attacks keep Iraqi oil off world markets for at least six months and oil prices average $37 in 2003 and $30 in 2004. In the "Worst" scenario, oil fields both in Iraq and other Arab countries are sabotaged and prices average $60 in 2003 and $40 in 2004.

Because this report and others in the press offered little guidance regarding the relative likelihood of alternative war outcomes, it seems likely that the reports contributed to, rather than reduced, the public's uncertainty regarding future oil prices.

A Role for Oil Futures Markets?

Beyond "expert" opinion and analysis, one might look to commodity and financial markets for indications of expected future oil prices. Perhaps the best-known of these is the market in exchange-traded oil futures contracts.[5] Using futures contracts to predict what the public will pay in the future on the spot market is tricky, however. In the January 2002 issue of *The Regional Economist,* William Emmons and Timothy Yeager explain that the oil market falls into the category of "storable commodities with modest inventories." In this case, prices on futures contracts are useful predictors of future spot prices if the futures-contract prices are lower than current spot prices (that is, the oil market displays *backwardation*) but are not useful predictors if futures-contract prices are higher than the spot price (the market displays *contango*).

During 2002-03, for the longer horizon of three to six months, the prices of oil futures contracts often were below the spot price, suggesting that market participants anticipated an increase in the spot price when war occurred (sometime before the middle of 2003) and a quick reversal later. But the picture is not clear-cut. At the shorter horizon of one month, perhaps more closely related to decisions to postpone purchases, the prices of futures contracts were sometimes above and sometimes below the spot price. This pattern suggests significant uncertainty among market participants regarding the future spot price.

"Saddam Securities"

During 2002-03, unlike the first Gulf War in 1990-91, there was a new financial-market security that allowed the public to bet on the outcome of the war and, implicitly, on the likely future path for oil prices.[6] In September 2002, the Irish Internet betting exchange www.tradesports.com offered a web page through which anyone could bet on when Saddam Hussein would be deposed as head of Iraq. Using credit cards as collateral, participants issued (sold) and purchased "Saddam Securities." The seller of a security agreed to pay the buyer $10 on the security's expiration date if Saddam Hussein was not leader of Iraq on that date, and zero otherwise.[7] Generally, analyses of this market have concluded that the prices of Saddam Securities accurately predicted later movements in oil prices.

To the extent that large numbers of people participated in this market, the Saddam Securities market might have provided valuable insight regarding the public's anticipated timing of future changes in oil prices. But if few people knew of the security, movements in the security's price might not have reflected a broad range of opinion. To test the likelihood that this market was well-known, we searched the database of a large information services firm for references to either Saddam Securities or www.tradesports.com beginning February 2002.[8] We found no mention of either the Saddam Security nor www.tradesports.com prior to February 2003. As a result, we conclude that movements in the security's price were probably of limited value as a measure of the public's expectations for future oil prices.

Impact of Previous Episodes

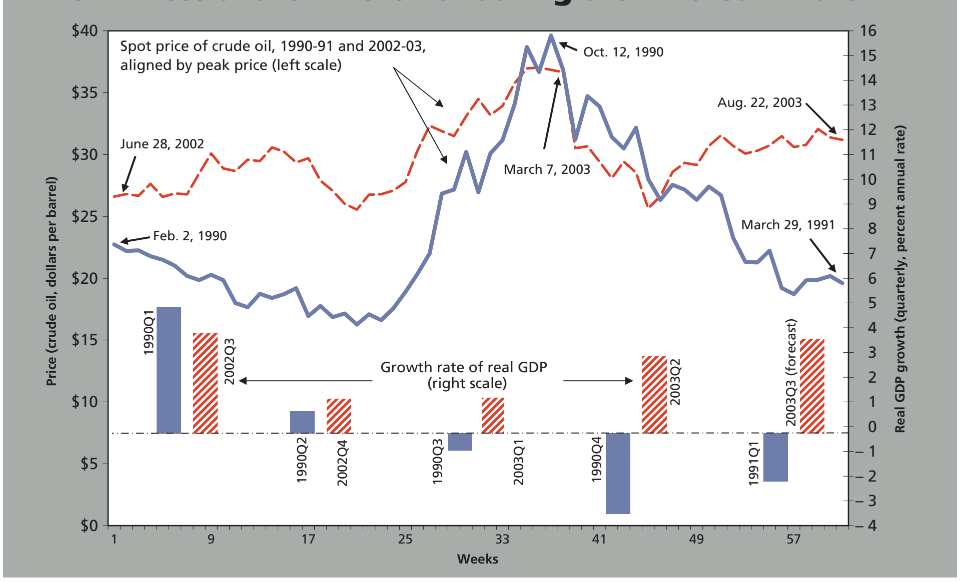
When in a new situation, almost all people use their past experience to guide their actions. During 2002-03, both consumers and businesses probably recalled the pattern of oil-price fluctuations during the first Gulf War of 1990-91. In retrospect, oil price fluctuations during both periods were similar, as shown in the figure. To the extent that the public's anticipations of future oil prices during 2002-03 were guided by their 1990-91 experience, any increase in uncertainty might have been small—and any slowdown in economic activity caused by factors other than oil. But this conclusion must be tempered by differences between the two conflicts. The second Gulf War, when it came, was an invasion of a hostile nation, not the liberation of a friendly one. On the opposite side was the greatly reduced importance during 2002-03 of Iraq and Kuwait as world oil suppliers relative to 1990-91, suggesting that the impact of a second Gulf War on world oil supplies would be smaller than the first. On balance, we find no way to assess the role of previous experience relative to oil price uncertainty during 2002-03.

Conclusions

Economic studies suggest that sharp increases in oil prices can significantly affect the pace of economic activity if they increase uncertainty regarding future oil prices. It seems reasonable that such uncertainty increased during late 2002 and early 2003, but measuring the increase is difficult. We have reviewed several indicators that were available to the public and policy-makers. Unfortunately, none of the indicators provides a clear signal. Although sharp increases in oil prices likely contributed to the economic slowdown during the fourth quarter of 2002 and the first quarter of 2003, confirmation of this effect awaits further research into measuring how changes in oil prices—and increases in political uncertainty—affect consumer and business spending behavior.

Richard G. Anderson is a vice president and economist in the Research Division of the Federal Reserve Bank of St. Louis, and Michelle T. Meisch is a research associate there.

Oil Prices and GDP Growth during the Two Gulf Wars



ENDNOTES

1. All five major oil shocks to the economy between World War II and 2002 coincided with military conflicts in the Middle East, making it impossible to disentangle uncertainty due to oil prices from uncertainty due to war. The prospect of war itself may cause retrenchment by firms and households, regardless of oil price increases.
2. On balance, forecasters surveyed by the *Blue Chip Economic Indicators* during the first week of September anticipated fourth-quarter and first-quarter real GDP growth at 2.9 and 3.4 percent annual rates, respectively. As late as the first week of December, the *Blue Chip* consensus anticipated first quarter growth at a 2.7 percent pace, rather than the actual 1.4 percent pace.
3. Hamilton (2003) surveys the links between oil prices and economic activity.
4. These scenarios were first discussed at a Center for Strategic and International Studies conference on Nov. 12, 2002, and were updated during a press briefing on March 13, 2003. See www.csis.org/features/iraq.htm, "The Cost of War" section. See also "Oil and War," a special report in *Business Week,* March 17, 2003.
5. Oil futures contracts are traded on the New York Mercantile Exchange, www.nymex.com. Contract prices are available in major daily newspapers, on the exchange's web site and in this Bank's monthly *National Economic Trends.*
6. Leigh, Wolfers and Zitewitz (2003).
7. The betting exchange allowed issuers to choose a variety of expiration dates; the key dates are December 2002, March 2003 and June 2003. The exchange provided only a forum for the participants, never issued or bought any securities, and debited the losers and credited the winners via their credit cards.
8. We used the database of a major information services company (Factiva) that indexes more than 8,000 publications.

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Community Profile

The Collierville Challenge

Can this rapidly growing Memphis suburb balance growth with preservation of its small-town identity?

By Laura J. Hopper

The heart of Collierville, Tenn., is its historic town square, built in 1870 as the town re-emerged from Civil War destruction. Take a walk down Main Street to view the train depot and the Confederate Park gazebo, the corner gas station and the barbershop, and you could believe you've stepped into another era.

But take a step back and view this southeastern Memphis suburb through a broader lens, and you'll see explosive population growth—from 14,427 in 1991 to 37,044 in 2002—as well as booming corporate development and burgeoning residential and retail construction. All that, plus small-town charm and historic ambience, should be enough to make Mayor Linda Kerley a very satisfied civic leader. But Collierville's rapid growth has challenged Kerley and other town officials as they try to preserve Collierville's past while preparing for its future.

"We don't want to grow just for growth's sake," Kerley says. "We want the right kind of development that can sustain itself in the future."

Town leaders fear that unplanned growth will drive residents away for the very reasons they moved to Collierville—to escape crowded city streets and to enjoy the benefits of a suburb with a small-town atmosphere. Says Town Administrator James Lewellen, "We don't want to become such a large commercial center that we're no longer an attractive place to live."

Kerley adds, "We like to joke that Collierville is the region's worst-kept secret. But you can't just close the door and not let anyone in. What you need is a healthy growth plan for the future."

Mapping the Ideal Suburb

Land-use planning comes naturally for any town in Tennessee, where state law requires all unincorporated land to be earmarked to a specific town for future annexation. But Collierville has gone the extra mile in this regard. Residents and officials spent three years on a land-use plan, which specifies how every block of the community will be developed, not just the 28.7 square miles within Collierville's borders but also the 20.9 miles the town could annex in the future.

The land-use plan is just the starting point, though, of Collierville's efforts to control development, particularly of the commercial variety. Businesses seeking to locate in the town face a detailed application process marked by scrutiny of every aspect of their planned development, Kerley says—from structural safety to landscaping to even color.

"When Home Depot wanted to locate here, we asked them to soften the orange," Kerley says, referring to the home improvement store's exterior, which is usually heavily orange.

As a result, the Collierville Home Depot kept the orange only in its sign; the rest of the building is red brick. "They weren't too happy about it at first, but this has been a very lucrative location for them since they opened here," Kerley says.

Opponents of Kerley's administration have criticized the tough regulatory standards, saying they

Collierville
BY THE NUMBERS

Population	**37,044 (2002)**
Labor Force	**8,320 (June 2003)**
Unemployment Rate	**2.3% (June 2003)**
Per Capita Personal Income	**$33,203 (2002)**
Top Five Employers	
FedEx World Tech Center	2,900
Carrier Corp.	1,600
Town of Collierville (government)	395
Alpha Corp.	300
PepsiAmericas	300

create an unfriendly environment for attracting new businesses to town. Kerley responds by saying she believes the bottom-line results are what will help Collierville continue to attract new businesses that see a growing town with an attractive landscape and an affluent population. "Companies want to come here because they know the businesses next door to them will be held to the same high criteria."

And having a detailed plan for future growth is important not just to Collierville but to the Memphis region as a whole, believes Susan Adler Thorp, spokesperson for Shelby County Mayor A C Wharton Jr. "It's great that the east section of our region has grown dramatically, but it's also important to control that with a plan for smart growth in the city, where the infrastructure already exists," she says.

Collierville and other suburbs are working with the city of Memphis on a regional smart growth plan, says Thorp, adding that, with proper planning, growth in one part of the region can be good for everyone. "When we're trying to recruit people and corporations, the entire Memphis region benefits from the presence of a community like Collierville, with a small-town atmosphere and good schools and neighborhoods."

"Where Their Talent Wants to Live"

Before its growth spurt of the past two decades, Collierville was a predominantly agricultural town, supplemented with some manufacturing firms. The largest of those is the heating and air-conditioning manufacturer Carrier, which opened its Collierville facility in 1967. Carrier has grown with the town, and the company recently completed a $27 million expansion project that added 400 jobs in Collierville.

Manufacturers—particularly in plastics and refrigeration—continue to be a staple of Collierville's economy, but manufacturing isn't likely to ever be the town's economic bread-and-butter, Lewellen notes. "We're not going to attract the smokestack industries because of our high cost of land," which is $40,000 per acre, he says.

Instead, Collierville is focusing on a new niche—smaller corporate offices and headquarters, Lewellen says. The new jobs will most likely target white-collar, higher-income workers, the suburb's fastest-growing group of residents.

"Corporate headquarters can locate anywhere they want to be," Lewellen says. "So they're going to go where their talent wants to live, and we're hoping that their talented people will want to live in Collierville."

The community's corporate "crown jewel," as Lewellen puts it, is the 140-acre FedEx World Tech Center, which serves as the technology arm and software development headquarters for FedEx Corp. With 2,900 employees, the multimillion dollar center will play a key role in Collierville's economic future, Lewellen says.

"With FedEx here, we can afford to be patient and selective while knowing that we can attract some more first-class commercial development in the future," he says.

Several new companies have already opened headquarters and administrative offices in Collierville over the past three or four years, including Helena Chemical, an agriculture chemical firm; ThyssenKrupp Elevator, North America's largest elevator company; and Parker Automotive Connectors, which manufactures parts for vehicle air-conditioners.

Many of these employers have opened offices in Schilling Farms, another key component of Collierville's development plans. The multiuse, 450-acre development also includes several residential subdivisions, two apartment complexes, a YMCA, a middle school, a church and a hotel. And residents will have more shopping options available soon as well, with construction under way on Carriage Crossing at Collierville, an 810,832-square-foot shopping center that will have three anchor tenants when it is completed in the spring of 2005.

Urban Sprawl or Suburban Success?

Even as Collierville attracts new business, its growth does not appear to be at the expense of the rest of the Memphis region—at least not yet, says Dexter Muller, vice president of economic development for the Memphis Regional Chamber of Commerce.

Traffic patterns show a majority of suburban residents still commuting westward toward the city of Memphis each day for work and shopping, Muller says. That includes the residents of Collierville, located 20 miles east of Memphis, and Germantown, the closer, first-ring suburb just east of Memphis.

The trend toward faster growth in suburbs than in cities continues throughout the Federal Reserve's Eighth District as well as in the Memphis region. "Like most urban areas, Memphis has experienced considerable sprawl during the last half of the 20th century," says University of Memphis Economics Professor David Ciscel in his report, "Urban Sprawl, Urban Promise: A Case Study of Memphis, Tennessee."

Ciscel adds: "From the 1950s through the 1990s, the city of Memphis grew east in Shelby County from the Mississippi River, along the Mississippi state line toward the very rural Fayette County. As the city enters the 21st century, the rest of Shelby County is ready to be annexed by the city or one of its smaller urban complements. … Soon the whole county will be urban."

In his 2001 *Regional Economist* article "Suburban Expansion," St. Louis Fed economist Ruben Hernandez-Murillo noted that such growth occurs because the benefits perceived by residents exceed the costs they incur. He adds that there are "limited scenarios where suburban expansion can be a problem." These scenarios arise if, when suburbs are expanding, there are costs to society as a whole that individuals do not take into account when deciding where to live.

For example, according to Hernandez, "commuting may involve additional time costs when roads are congested by excessive traffic." Or, when "converting land to urban use, developers do not take into account intangible benefits of open spaces that might be lost by other households." In addition, if developers do not pay the full costs of new infrastructure, there will tend to be too much development.

The FedEx World Tech Center (top) is located in Collierville, as is the headquarters of Parker Automotive Connectors (center). Parker and several other firms are located at Schilling Farms (bottom), a 450-acre, multiuse development.

For now, Mayor Kerley believes Collierville can handle such challenges—and remain a vibrant community well into the future. "Growth is coming to Collierville, and people want to be here," she says. "We want to maintain that healthy mix of new development and good residential neighborhoods, and not place the tax burden on our residents. That way, we can make this a win-win situation for everyone."

Laura J. Hopper is a senior editor at the Federal Reserve Bank of St. Louis.

National and District Data

Selected indicators of the national economy and banking, agricultural and business conditions in the Eighth Federal Reserve District

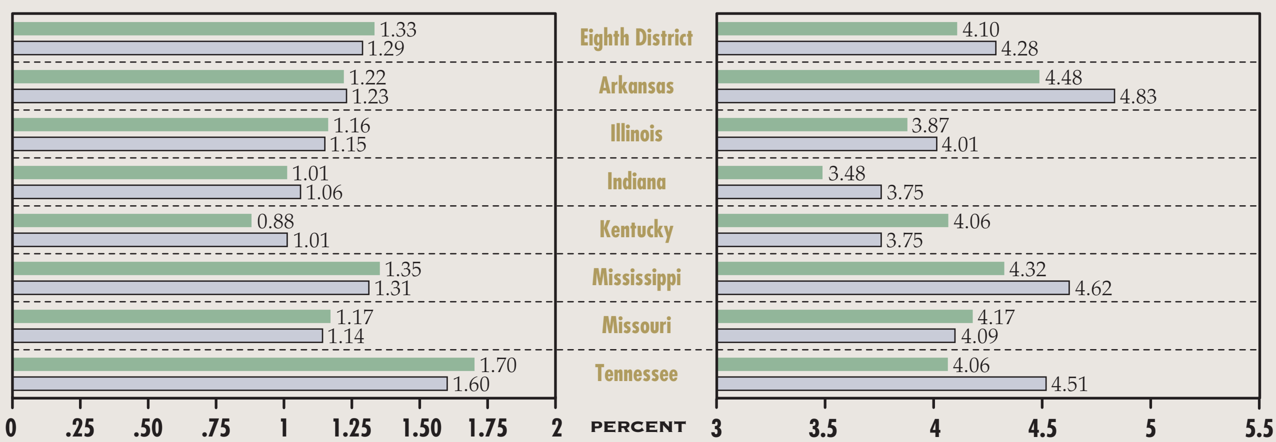
Commercial Bank Performance Ratios

SECOND QUARTER 2003

U.S. Banks by Asset Size	ALL	$100 MILLION-$300 MILLION	LESS THAN $300 MILLION	$300 MILLION-$1 BILLION	LESS THAN $1 BILLION	$1 BILLION-$15 BILLION	LESS THAN $15 BILLION	MORE THAN $15 BILLION
Return on Average Assets*	1.39	1.19	1.14	1.31	1.22	1.42	1.32	1.43
Net Interest Margin*	3.96	4.48	4.51	4.35	4.44	4.12	4.28	3.81
Nonperforming Loan Ratio	1.33	1.02	1.09	0.95	1.03	1.04	1.03	1.47
Loan Loss Reserve Ratio	1.81	1.40	1.42	1.50	1.46	1.74	1.59	1.92

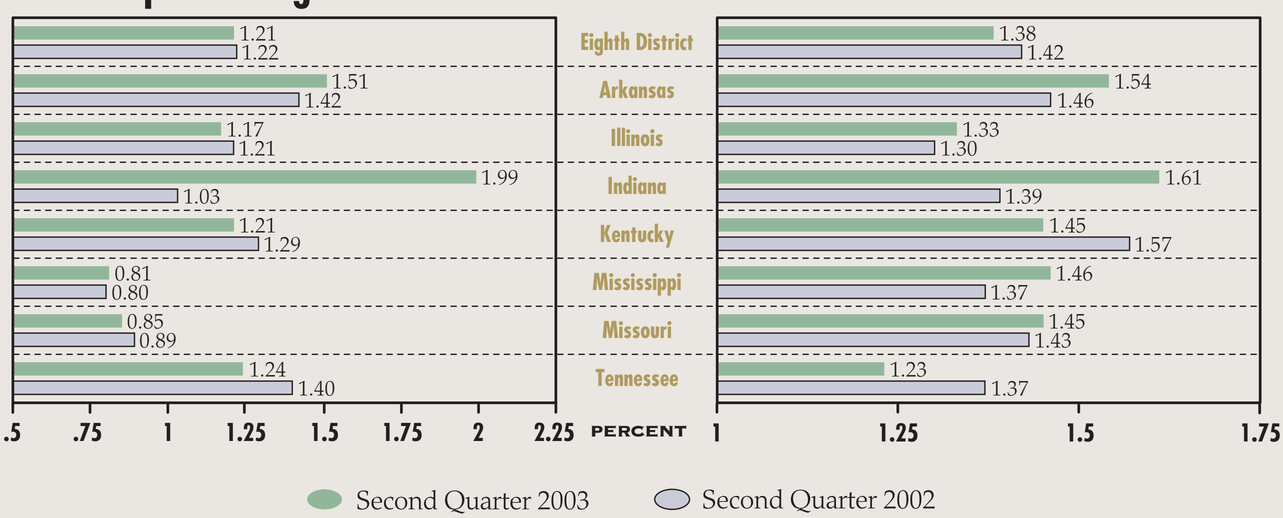
Return on Average Assets*

Net Interest Margin*



Nonperforming Loan Ratio

Loan Loss Reserve Ratio



NOTE: Data include only that portion of the state within Eighth District boundaries.
SOURCE: FFIEC Reports of Condition and Income for all Insured U.S. Commercial Banks
*Annualized data

For additional banking and regional data, visit our web site at: www.research.stlouisfed.org/fred/data/regional.html.

Regional Economic Indicators

Nonfarm Employment Growth*

YEAR-OVER-YEAR PERCENT CHANGE

SECOND QUARTER 2003

	UNITED STATES	EIGHTH DISTRICT	ARKANSAS	ILLINOIS	INDIANA	KENTUCKY	MISSISSIPPI	MISSOURI	TENNESSEE
Total Nonagricultural	–0.3%	–0.7%	0.1%	–0.9%	–1.0%	–0.9%	–0.2%	–1.4%	0.0%
Natural Resources/Mining	–2.9	–2.1	0.5	–0.7	–1.4	–3.9	4.5	–11.6	–5.7
Construction	1.0	–2.3	–2.0	–0.7	–5.6	–2.1	0.8	–2.2	–4.0
Manufacturing	–4.1	–2.9	–2.7	–3.2	–1.9	–2.8	–4.9	–3.1	–3.3
Trade/Transportation/Utilities	–1.0	–0.5	0.7	–0.5	–0.8	–1.6	1.6	–0.9	–0.6
Information	–4.0	–2.7	–2.8	–2.1	–2.7	–0.3	0.4	–5.5	–2.9
Financial Activities	1.8	0.0	0.6	0.0	–0.2	0.4	0.5	–0.2	0.0
Professional & Business Services	–0.2	–1.1	–0.5	–0.4	–5.3	–0.2	0.7	–2.8	1.4
Educational & Health Services	2.3	1.6	2.8	1.0	1.3	2.7	–0.9	0.8	4.0
Leisure & Hospitality	0.9	–0.8	2.0	–0.9	–2.2	–0.5	–1.3	–1.7	1.4
Other Services	–0.6	–0.8	–0.6	–0.6	1.0	–3.3	4.3	3.8	0.6
Government	0.1	–0.2	0.7	–1.5	2.4	–0.9	1.3	–2.0	1.0

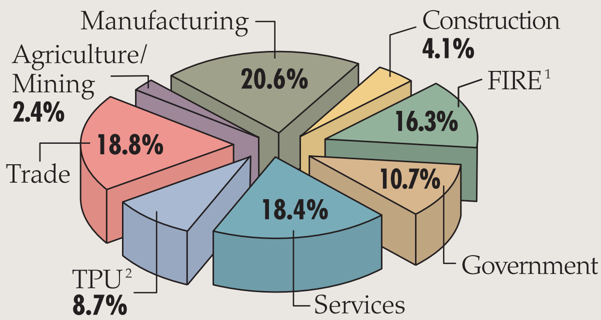
*NOTE: Nonfarm payroll employment series have been converted from the 1987 Standard Classification (SIC) system basis to a 2002 North American Industry Classification (NAICS) basis.

Unemployment Rates

PERCENT

	II/2003	I/2003	II/2002
United States	6.2%	5.8%	5.8%
Arkansas	5.5	4.9	5.5
Illinois	6.3	6.5	6.5
Indiana	4.9	4.8	5.2
Kentucky	5.8	5.6	5.7
Mississippi	6.7	6.2	6.9
Missouri	5.3	4.9	5.5
Tennessee	5.2	4.8	5.2

District Real Gross State Product by Industry—2001



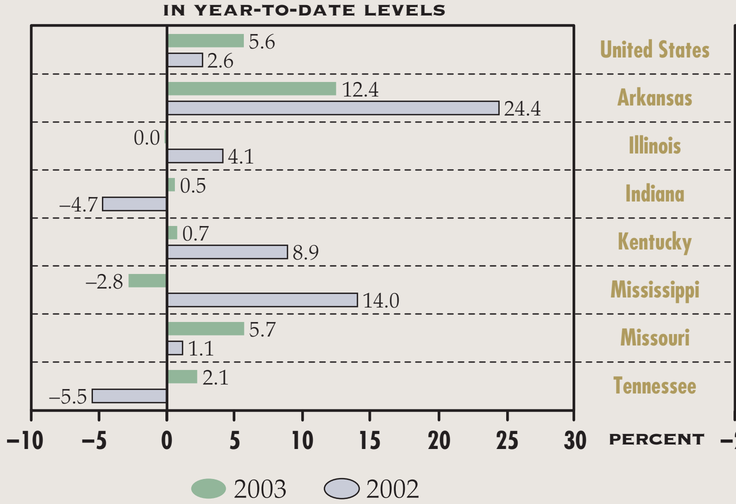
UNITED STATES $9,335 BILLION
DISTRICT TOTAL $1,191 BILLION
CHAINED 1996 DOLLARS

[1] Finance, Insurance and Real Estate [2] Transportation, Communication and Public Utilities

SECOND QUARTER

Housing Permits

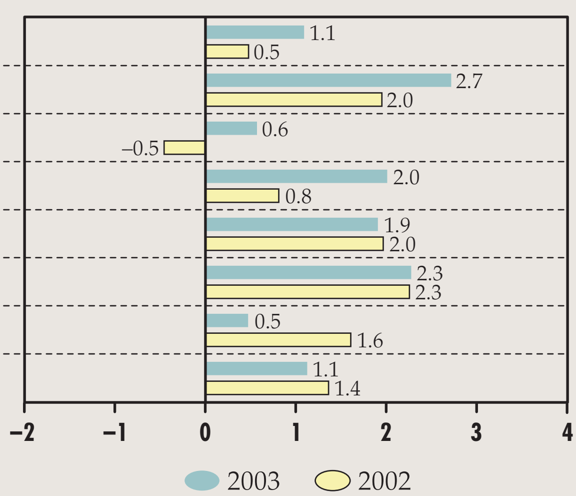
YEAR-OVER-YEAR PERCENT CHANGE IN YEAR-TO-DATE LEVELS



FIRST QUARTER

Real Personal Income*

YEAR-OVER-YEAR PERCENT CHANGE

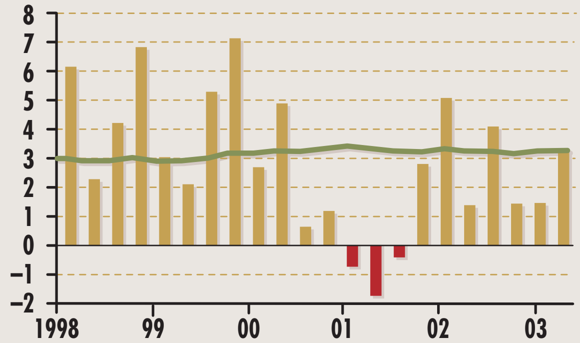


* NOTE: Real personal income is personal income divided by the PCE chained price index.

Major Macroeconomic Indicators

Real GDP Growth

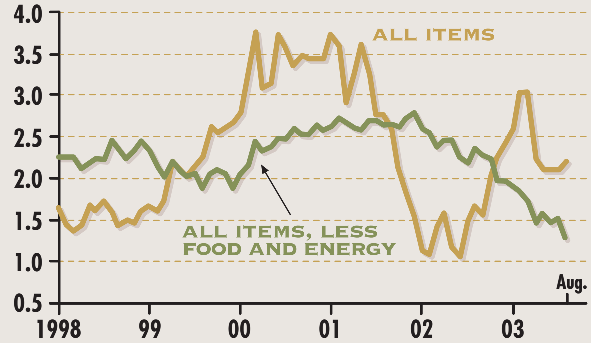
PERCENT



NOTE: Each bar is a one-quarter growth rate (annualized); the green line is the 10-year growth rate.

Consumer Price Inflation

PERCENT



NOTE: Percent change from a year earlier

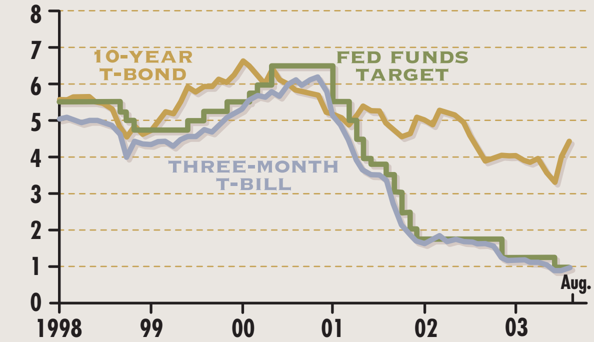
Civilian Unemployment Rate

PERCENT

NOTE: Beginning in January 2003, household data reflect revised population controls used in the Current Population Survey.

Interest Rates

PERCENT

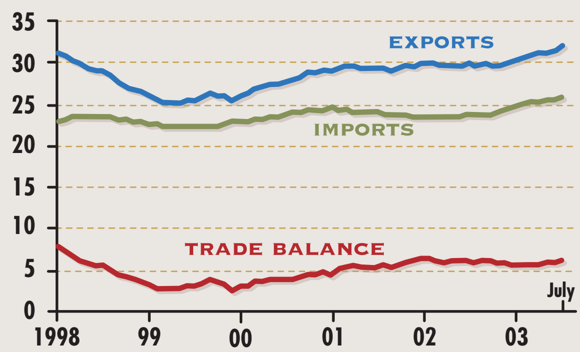


NOTE: Except for the fed funds target, which is end-of-period, data are monthly averages of daily data.

Farm Sector Indicators

U.S. Agricultural Trade

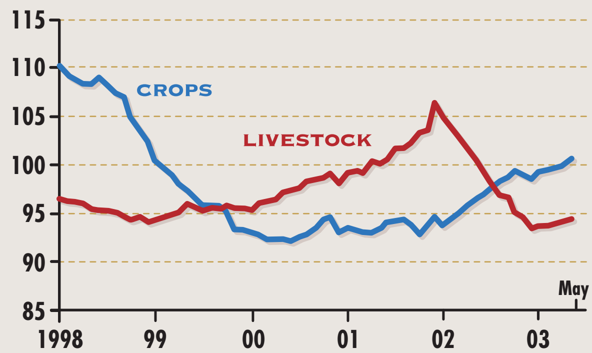
BILLIONS OF DOLLARS



NOTE: Data are aggregated over the past 12 months. Beginning with December 1999 data, series are based on the new NAICS product codes.

Farming Cash Receipts

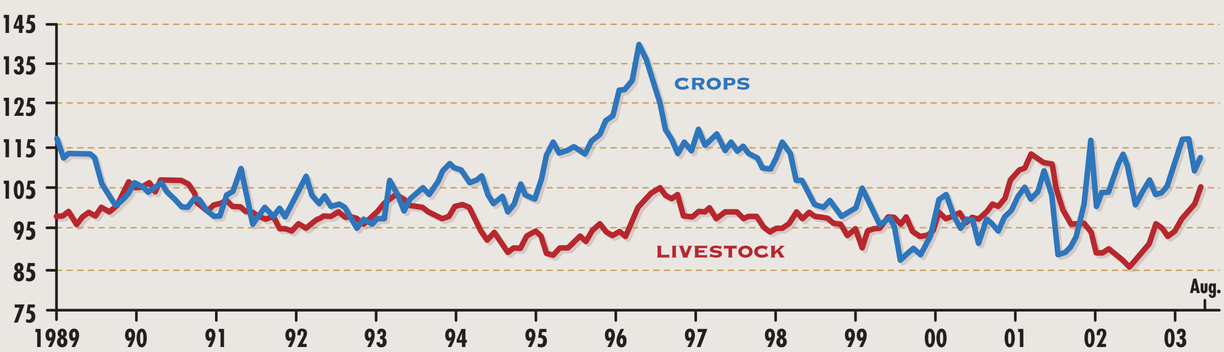
BILLIONS OF DOLLARS



NOTE: Data are aggregated over the past 12 months.

U.S. Crop and Livestock Prices

INDEX 1990-92=100



National and District Overview

Recessions, Expansions and Black Employment

By Howard J. Wall

ONE OF THE GREAT SUCCESSES OF THE 1990s ECONOMIC EXPANSION WAS THE RISE IN THE SHARE OF THE BLACK POPULATION THAT WAS EMPLOYED.

Between 1992 and 2000, the employment ratio (or employment-to-population ratio) for black men rose by 3.5 percentage points to 67.8 percent. This was the reverse of the downward trend of the 20 previous years, during which the employment ratio for black men *fell* by 8.7 percentage points. The 1990s expansion led to even larger gains for black women: In the eight years between 1992 and 2000, the employment ratio for black women rose by 7.7 percentage points to 61.3 percent, having risen by 7.1 percentage points in the previous 20 years.

Of course, because the gains from economic expansion are felt throughout the populace, employment rates for nearly all subgroups rose during the 1990s. But, even accounting for the overall improvements in employment, the 1990s expansion was a great success for African-Americans. In 1992, the overall black employment rate was 58.3, which was 5.3 percentage points lower than for whites. By 2000, however, the black employment rate had risen to 64.2 percent, which was only 1.9 percentage points lower than for whites.

The primary reason for the improvement in the relative position of black employment was that we didn't have a recession for almost 10 years. Recessions wreak havoc on the relative employment outcomes of blacks. Between 1972 and 2000, the gap between the employment rates of black and white men tended to rise by three-quarters of a percentage point during a year that the economy was in recession for part of the year. But expansions closed the gap more slowly than recessions opened it. For each year of recession, it took three years of expansion for the gap to return to its pre-recession level.

Recessions are even more destructive to the relative progress of black women. As with men, the gap between black and white women's employment ratios has tended to increase during a recession year by three-quarters of a percentage point. But during a year of expansion, the gap has tended to shrink much more slowly than this. In fact, for each year of recession over the past 33 years, it has taken about four years of expansion for the gap to return to its pre-recession level.

2000-03 Slowdown

According to the official recession-dating committee of the National Bureau of Economic Research, the recent recession began in March 2001 and ended in November of the same year. The employment slowdown, however, began earlier and lasted longer than this: The overall employment rate peaked at 66.2 percent in the first quarter of 2000 and fell steadily until the second quarter of this year, when it stood at 64.4 percent. In terms of their relative employment position, this recession appears to have had similar, but somewhat less severe, effects for black men than past recessions have had. By the second quarter of 2003, the gap between the white and black adult male employment rates was higher than three years earlier, but only by 1.2 percentage points. Past experience would have predicted an increase more than 2 percentage points.

The effect of the recession on the relative employment position of black women has differed from this somewhat. First of all, in the second quarter of 2000, the employment rate for black women was actually 3.4 percentage points higher than it was for white women. Nonetheless, the recession reduced the employment rate for black women more than it did for white women. By the second quarter of 2003, the employment rate for white women had fallen by only six-tenths of a percentage point compared to three years earlier. But for black women over the same period, the employment rate had fallen nearly four times as much, by 2.2 percentage points. Still, just as for the relative black male employment rate, it appears that this recession has been less severe than the average recession in its effect on the relative employment rate of black women.

Howard J. Wall is a research officer and the regional economics coordinator at the Federal Reserve Bank of St. Louis.