President's Message

"To be sure, CAFTA is not perfect. It is really a 'freer trade' rather than a 'free trade' agreement. Certain special interests were successful in creating important protectionist exceptions to the principle of free trade."

William Poole

PRESIDENT AND CEO,
FEDERAL RESERVE BANK OF ST. LOUIS

Despite Flaws, CAFTA Is Step in Right Direction

CAFTA, the trade agreement that President Bush signed in August, has faced some of the same criticism as its predecessor, NAFTA. But like the earlier agreement, CAFTA will benefit each of the participating countries.

The Central American Free Trade Agreement breaks down most trade barriers between the United States and five nations of Central America (Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua) plus the Caribbean country of the Dominican Republic. Most products from this region already were entering the United States duty-free, but CAFTA will make sure more U.S. products and services get the same treatment down south.

To be sure, CAFTA is not perfect. It is really a "freer trade" rather than a "free trade" agreement. Certain special interests were successful in creating important protectionist exceptions to the principle of free trade.

But it's important to remember that similar problems, fears and shortcomings surrounded NAFTA when it was passed more than 10 years ago. Yet today, most U.S. economists agree NAFTA has succeeded not only in Mexico and Canada, but also in the United States. Without question, the economies of the NAFTA countries have become more and more integrated. Some evidence:

- Total two-way trade between the United States and our NAFTA partners grew a remarkable 111 percent between 1993 and 2003, while total two-way trade between the United States and the rest of the world grew by 79 percent.
- Because NAFTA reduced or eliminated most barriers that limit access to goods, U.S. exporters have greater market access and a price advantage over competitors such as Japan, South Korea and China.
- NAFTA provisions in the auto sector allow U.S. automakers to treat the participating countries as a single market, maximize efficiencies and become competitive on a global scale.
- Mexico's investment in the United States increased 280 percent from 1994 to 2002, while investment in the United States by non-NAFTA countries grew by 185 percent.

Critics blame NAFTA, CAFTA and other trade agreements for large-scale job losses. But most of the U.S. jobs that are lost are low-wage, low-skill jobs. These losses force workers to train for higher-skill, higher-paying jobs—the kinds we want. What trade expansion does in the U.S. labor market, essentially, is to expand employment in higher-paying industries and occupations and depress it in lower-paying jobs. In fact, the net impact on the number of U.S. jobs is negligible. However, the individuals who are helped are not the same as those who are hurt. That fact provides the rationale for government trade-adjustment assistance. Meanwhile, companies can help to cushion the blow of unemployment by providing ample notification of plant closings and assistance to departing employees.

The real issue with regional trade pacts is that they can prevent U.S. consumers from enjoying the benefits of even cheaper goods that might be available from countries not included in the regional agreements. However, it is probably true that in the absence of greater progress on truly multilateral trade agreements to expand trade for all countries, progress on freer trade through regional agreements is constructive, if only because it keeps the public debates and the momentum for freer trade alive.

In the end, we must remember that trade restrictions can be very costly. A study by economists Gary Clyde Hufbauer and Kimberly Ann Elliott showed that consumers were paying an average of $139,000 for each job protected in 1990 in the apparel industry, an industry in which the typical production worker made less than $15,000. In the sugar industry, the consumer loss for each job that was saved totaled $600,000!

Finally, CAFTA is about more than trade. U.S. sales to that region totaled a mere $15 billion a year before the pact—about 2 percent of total exports—and certainly won't skyrocket anytime soon. But trade agreements also promote democratic and economic reform. A greater sense of economic opportunity and progress creates more stable political environments. These benefits were emphasized in the debate over NAFTA, and Mexican experience over the past decade seems to bear out the optimists.


INSURANCE
INVESTMENT
STOCKS

The Door Is Open, but Banks Are Slow To Enter Insurance and Investment Arenas

By Ellen Harshman, Fred C. Yeager and Timothy J. Yeager

More than five years have passed since Congress enacted the Gramm-Leach-Bliley Act, tearing down regulatory barriers that separated commercial banking, investment banking and insurance underwriting. Many thought the new law would create a profusion of "universal banks," whose one-stop shop for financial services would not only make money for them but save money for consumers. Have these benefits come to pass?

The biggest potential benefit of the law is that it allows financial institutions to exploit fully the revenue efficiencies and cost savings that accrue from offering an array of financial services. The concept is similar to a grocery that also houses a pharmacy and a video rental department. The grocery earns additional revenue because the shopper buying a gallon of milk finds it convenient to fill a prescription and rent a movie. The grocery also sheds costs relative to three stand-alone stores because it can use the grocery's back-office functions, such as inventory, accounting and marketing systems, to service the pharmacy and video department. Shoppers benefit from added convenience and lower costs.

Similarly, consumers conceivably can go to their local bank to deposit funds, add the teenage driver to the insurance plan and invest savings in a mutual fund. In addition, business customers may wish to borrow money by taking out a bank loan or by selling corporate bonds. With the same banking organization handling both activities, businesses save time and money by going through the costly process of proving their creditworthiness to only one firm instead of two or more firms. Because of these advantages, supporters of the Gramm-Leach-Bliley Act promised it would save consumers billions of dollars.[1]

Despite the hype over the act, many analysts argued that it would have only minor effects on the financial industry because the potential revenue gains and cost savings from creating universal banks are small. To the extent that these advantages exist, banking organizations had already found ways to exploit them partly before March 2000—the month that the act took effect—by conducting investment banking activities in so-called Section 20 affiliates. (See article on Page 7.) The legislation simply made it easier for organizations to continue to engage in the activities they had already undertaken.

More than five years have passed since the adoption of the act, enough time to examine the early impact that the legislation has had on the banking industry. The evidence, thus far, suggests that the effects of the law have been modest; consequently, banking customers should not expect significant price reductions for their primary financial services. Two pieces of evidence lead to this conclusion.[2] First, most financial holding companies (FHCs) continue to conduct traditional commercial banking activities; very few firms are also engaged heavily in insurance underwriting and investment banking. Second, FHCs on average are no more profitable or cost-efficient than they were before passage of the legislation.

Five Years After Gramm-Leach-Bliley,
Financial Holding Companies Are Few in Number, Big in Size

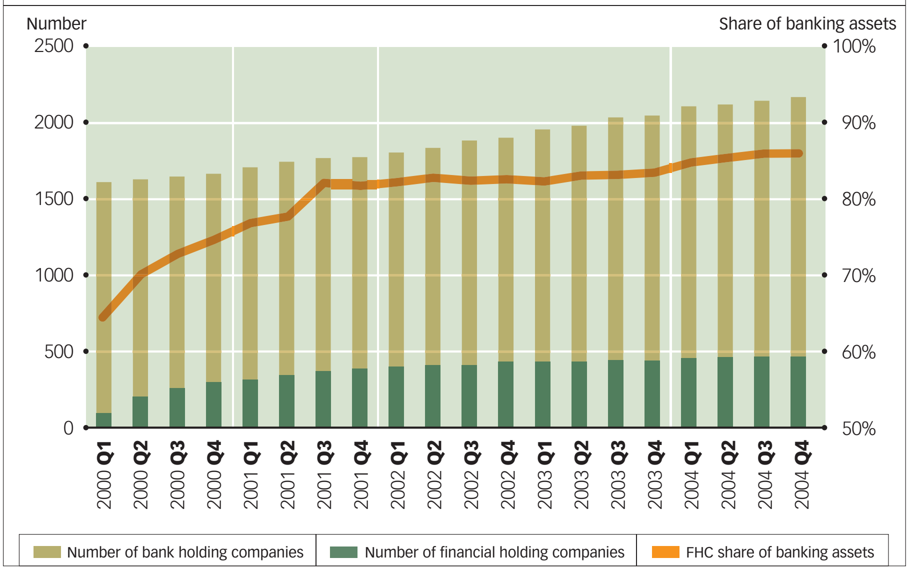

TABLE 1

The FHC Metamorphosis

	Before becoming an FHC, the average BHC had these ratios:	Three years after becoming an FHC, the average FHC would have these ratios:
Balance sheet ratios (percent of total assets)		
Loans	62.30	**58.90**
Securities	25.80	**27.80**
Deposits	79.40	**80.40**
Equity	9.21	**9.59**
Income ratios (percent of average assets)		
Interest income	7.49	7.46
Interest expense	3.47	**3.39**
Net interest income	4.02	4.07
Noninterest income	1.58	1.7
Noninterest expense	3.55	**3.76**
Provision expense	0.23	**0.32**
Net income (ROA)	1.28	1.19
Return on equity	13.92	**12.78**
Performance ratios (percent)		
Efficiency ratio	62.60	**64.30**

NOTE: Ratios in bold indicate statistically significant changes.

FHCs Move Slowly

One measure of the impact of the act on the financial services industry is the extent to which financial holding companies have taken advantage of their new powers to conduct insurance and investment banking activities. The larger the cost savings and revenue benefits, the more quickly banks should respond to the legislation.

To take advantage of the act, firms must become financial holding companies. The chart above plots the number of FHCs and BHCs—bank holding companies that have not elected to become FHCs—between March 2000 and December 2004.[3] The number of FHCs increased rapidly from 94 in March 2000 to 466 in December 2004; nevertheless, FHCs have never accounted for more than 23 percent of all banking organizations. As a percentage of assets, however, FHCs account for a significant share of total banking assets because most large banking organizations elected to become FHCs shortly after passage of Gramm-Leach-Bliley. As the line in the nearby chart shows, in March 2000, FHCs accounted for 65 percent of industry assets; their share in December 2004 was 86 percent.

A firm's designation as an FHC does not necessarily mean that it is engaging in insurance underwriting or investment banking. Indeed, the process to become an FHC is quite simple. To be eligible, each depository institution controlled by the banking organization must be well-capitalized and well-managed as of the date the company submits its declaration, and it must have a satisfactory Community Reinvestment Act (CRA) rating from its primary bank regulator. An election to become an FHC is effective on the 31st day after the date that the declaration was received unless the Federal Reserve's Board of Governors notifies the company prior to that time that the election is ineffective. The organization need not ever conduct the newly permissible activities authorized under Gramm-Leach-Bliley.

One indication of the weak response of the banking industry to the law is that, to date, financial holding companies are involved only modestly in their new universal banking powers to conduct investment banking and insurance underwriting. Moreover, the few that are heavily engaged in these activities are the large money-center banks that dominated the banking industry even before passage of the act. On average, FHCs hold less than 1 percent of assets in investment banking subsidiaries and just 0.24 percent of assets in insurance subsidiaries, and these activities account for just 7 percent of revenue. In fact, investment banking and insurance underwriting are highly concentrated in just a few financial holding companies. As of December 2004, of the 41 FHCs that held any investment banking assets at all, three organizations—Citigroup, Bank of America and JPMorgan Chase—accounted for 72 percent of the total. Moreover, of the 22 FHCs with insurance underwriting assets, just two firms—MetLife and Citigroup—accounted for 96 percent of the total, and the concentration has since increased. In the first quarter of 2005, Citigroup sold the bulk of its life insurance business to Met Life. It had already sold its property and casualty business in 2002. Citigroup's rationale was that the capital could be invested more profitably in other lines of business.

In sum, of the nearly 500 financial holding companies, only a handful of them have significant investment banking and insurance operations. Most FHCs are not that different from more traditional banking organizations. The lack of activity provides circumstantial evidence that the synergies between these activities are relatively weak.

FHC Performance Then and Now

A more direct approach to observing the effects of Gramm-Leach-Bliley on financial institutions is to measure changes to a bank's balance sheet and profitability after it becomes an FHC. Statistical techniques can isolate and measure the average change in performance after banks become FHCs relative to their performance before becoming FHCs.[4] We analyzed bank performance between the years 1996 and 2003, assessing the marginal contribution from becoming an FHC. The results are in Table 1 on Page 6.

Three years after becoming an FHC, the average banking organization shows modest changes to its balance sheet. The typical BHC holds $62.30 in loans for every $100 in assets; that amount drops to $58.90 three years after becoming an FHC. The drop in loans is expected because the organization presumably is diversifying into insurance and investment banking assets. As a percent of assets, securities holdings increase by two percentage points, and deposits increase by one percentage point. Equity—the difference between assets and liabilities—increases somewhat after a firm becomes an FHC. The boldfaced font indicates that all of these changes are statistically significant—that is, the changes are not simply the result of chance. Yet, given the relatively wide dispersion of loan, securities, deposit and equity holdings among banking organizations, none of these changes is economically large.

In addition to the balance sheet changes, the typical FHC shows a slight decline in profitability. A banking organization that transitions from loan-making to insurance underwriting and investment banking would expect to see its interest income decline while its noninterest (fee) income increases. After all, insurance and investment banking are fee-driven services. Indeed, the typical FHC experiences these changes. Interest income as a percent of average assets declines by three basis points, while the ratio of noninterest income to average

As Memories Fade, So Do Restrictions on Banks' Activities

To place the Gramm-Leach-Bliley Act in historical context, it is helpful to examine the legislative events that separated banking from insurance and investment banking. The National Banking Act of 1864, which established the national bank charter, permitted banks to engage only in activities that were "incidental" to the business of banking. Insurance activities were excluded. Securities activities, however, were permissible as long as banks conducted these activities through affiliates. Investment banking grew quickly in the 1920s, fueled by the explosion in bond underwriting to finance World War I and a booming economy and stock market.

The stock market crash of 1929 ushered in the Great Depression. Because of the perception that banks' involvement in securities activities facilitated the Depression, Congress passed the Glass-Steagall Act of 1933, which prohibited banks from issuing, underwriting, selling or distributing any type of securities with the exception of U.S. government and government agency securities and certain municipal bonds.

By the 1970s, Depression-era conditions had faded from the minds of the American public. In turn, the rationales for the compartmentalization of the financial sector were questioned. A number of government-mandated studies called for banking deregulation and greater reliance on market forces.[1] In addition, several studies argued that securities activities of commercial banks were not significant factors leading to the banking crises during the Great Depression.[2] (See article on Page 8.)

Barriers between commercial banking and investment banking were lifted gradually. Under Section 20 of the Glass-Steagall Act, banks were prohibited from affiliating with other financial institutions that were "engaged principally in the issue, floatation, underwriting, public sale or distribution of financial assets." Over the years, however, the term "engaged principally" became subject to reinterpretation. Through a series of court rulings and Federal Reserve Board interpretations, the type of securities and the proportion of assets that bank affiliates could devote to these securities were broadened. By 1996, bank affiliates were allowed to derive up to 25 percent of their revenue from underwriting corporate bond and equity issues. By late 1999, with passage of the Gramm-Leach-Bliley Act imminent, the number of so-called Section 20 banks stood at 45.

Given the gradual breakdown of Glass-Steagall and the merger-led growth of bank holding companies in the mid-1990s, the largest banking organizations pressed for congressional action to repeal fully Glass-Steagall and other barriers in the hopes of further exploiting revenue efficiencies and cost savings. Citigroup received a temporary exemption in September 1998 from the Federal Reserve to buy Travelers Insurance, with the expectation that Congress would act before the exemption expired.

On Nov. 12, 1999, laws separating commercial banking, investment banking and insurance activities for U.S. institutions were effectively removed with the enactment of the Gramm-Leach-Bliley Act. Banking organizations have since been allowed to form financial holding companies and to engage in any activity that is financial in nature.

[1] See, for example, Benston (1972).

[2] See White (1986); Ang and Richardson (1994); Kroszner and Rajan (1994).

Re-emergence of Universal Banking Raises Specter of Earlier Banking Crisis

Will the re-emergence of universal banking authorized under the Gramm-Leach-Bliley Act harm investors and reintroduce instability into the U.S. financial system? This question presumes that universal banks were harmful to the financial system in the 1930s.

The Glass-Steagall Act of 1933 separated commercial banking from investment banking because of the perception that organizations commingling these activities harmed public investors and contributed to the banking crisis during the Great Depression. Two related arguments were advanced by Sen. Carter Glass, D-Va., and others in the early 1930s to separate commercial and investment banking.

First, universal banking creates significant conflicts of interest within the firm—conflicts that potentially harm investors. Suppose a bank has a loan outstanding to a corporate customer, and the bank—but not the public—knows that the credit-worthiness of the customer is deteriorating. The universal bank has an incentive to repackage the loans into securities and misrepresent the quality of the securities to the unsuspecting public. Alternatively, investment analysts of the universal bank might provide overly optimistic assessments of a firm's earnings potential if the bank also has a lending relationship with the firm.

Second, the volatile investment banking business could contribute to banking instability by draining the commercial bank's capital or by harming the bank through reputational risk. The investment bank might take even more risk, knowing that the bank would bail it out if the business soured.

But recent research disputes these perceptions.

If universal banks exploit their information advantage to underwrite corporate securities so that the corporation can pay off a high-risk bank loan, then securities underwritten by universal banks should be riskier and have higher defaults than securities issued by stand-alone investment banks. The evidence from the 1930s suggests the opposite to be true.[1]

The evidence also refutes the notion that universal banks fostered banking instability.[2] In fact, banks that had investment banking affiliates were less likely to fail in the 1930s than banks without such affiliates. In addition, investment bank affiliates did not drain equity from commercial banks.

Finally, commercial bank earnings and investment bank earnings were not highly correlated, suggesting that universal banks may have had more stable earnings than stand-alone banks.

That universal banks did not contribute negatively to the 1930s banking crisis is not proof that they are a good idea today. The conflicts of interest and potential for financial instability still remain. Indeed, JPMorgan Chase and Citigroup—banking organizations that had exemptions to engage in limited investment banking before passage of the Gramm-Leach-Bliley Act—recently paid fines over their alleged role in fueling the Enron boom and bust.[3] One of the charges was that they used creative bank financing to lend to Enron to court more investment banking business. Another charge was that analysts at the banks were promoting Enron to investors even when the analysts knew the firm was financially unsound.

Despite the potential for abuse from universal banking, today's financial environment is much more tightly regulated than the pre-Depression financial environment. The Securities Act of 1933 requires corporations to register their securities with the Securities and Exchange Commission. Investors can be better informed, which helps them to make better investment decisions. One study documents the reduction in the variance of investor returns following implementation of the Securities Act.[4]

Bank regulation has also improved. The introduction of federal deposit insurance came with mandated safety and soundness examinations. Examiners can limit capital distributions from a troubled bank and force recapitalization if necessary. In addition, affiliate transactions must be done at arm's length. In other words, a commercial bank cannot give lending terms to its affiliates that are better than others could get in a competitive market. These changes limit the ability of a troubled investment banking affiliate to drain equity from the commercial bank.

Given that universal banks contributed little to the 1930s banking crisis and that stronger regulations are in place to prevent abuse, the return of universal banking in the United States is unlikely to contribute to financial instability.

[1] See Kroszner and Rajan (1994) and Ang and Richardson (1994).
[2] See White (1986).
[3] See McLean and Elkind (2003).
[4] See Simon (1989).

assets jumps by 13 basis points. However, the increase in noninterest income is offset by an even larger increase in noninterest (or overhead) expense. Noninterest expense to average assets surges by 21 basis points. In addition, provision expense—the income set aside to cover future credit losses—increases by nine basis points. Overall profitability, then, as measured by return on assets, slips by nine basis points to 1.19 percent, and return on equity drops by 114 basis points due to the drop in net income and the increase in equity. Only about half of the income ratio changes are statistically significant.

Do the FHCs gain cost advantages relative to BHCs? The increase in noninterest expense noted above suggests that the answer is "no," and another measure—the efficiency ratio—confirms this result. The efficiency ratio is calculated as overhead costs divided by operating income. Intuitively, the efficiency ratio shows how much overhead the organization spends to earn $1 in operating income. Lower values signal better cost efficiency. The average BHC between 1996 and 2003 had an efficiency ratio of 62.6 percent, suggesting that it took 63 cents in expenditures to yield a dollar in operating income. Three years after becoming an FHC, however, that ratio increased to 64.3 percent. In other words, FHCs were less cost-efficient than they were as BHCs. To be sure, part of the increase in costs may reflect one-time expenditures to acquire and absorb investment banking and insurance units into the organization. In the short run, however, FHCs did not gain a cost advantage over BHCs.

Are the Section 20 Banks Different?

As the article on Page 7 notes, Section 20 of the Glass-Steagall Act allowed the Federal Reserve to grant permission to select banking organizations to conduct limited investment banking activities prior to passage of the Gramm-Leach-Bliley Act. Some organizations began underwriting previously ineligible debt and equity issues as early as 1986. It could be the case that only those firms with previous securities activities (through Section 20 exemptions) were in a position to take immediate advantage of the new universal banking powers granted in the Gramm-Leach-Bliley Act. If so, a separate analysis of the so-called Section 20 FHCs—FHCs that had Section 20 affiliates before passage of the act—may reveal synergies between investment banking and commercial banking that are absent in other FHCs.

Indeed, such an analysis shows that three years after becoming Section 20

TABLE 2

The Section 20 FHC Metamorphosis

	Before becoming an FHC, the average Section 20 BHC had these ratios:	Three years after becoming an FHC, the average Section 20 FHC would have these ratios:
Balance sheet ratios (percent of total assets)		
Loans	60.30	**52.10**
Securities	18.10	**22.30**
Deposits	64.00	**65.50**
Equity	7.75	**8.43**
Income ratios (percent of average assets)		
Interest income	7.04	**6.66**
Interest expense	3.49	**3.21**
Net interest income	3.55	**3.45**
Noninterest income	2.77	3.00
Noninterest expense	3.89	4.06
Provision expense	0.36	**0.49**
Net income (ROA)	1.38	1.24
Return on equity	17.38	**14.91**
Performance ratios (percent)		
Efficiency ratio	61.80	63.20

NOTE: Ratios in bold indicate statistically significant changes.

FHCs, the organizations sharply reduce their loan holdings by 8.2 percentage points and they increase securities holdings by 4.2 percentage points. In addition, the ratio of equity to assets increases by 68 basis points. All of these changes, which can be seen in Table 2 above, are statistically significant.

Despite the balance sheet changes, there is little evidence to support profit or cost advantages for Section 20 FHCs. Interest income decreases by 38 basis points, although noninterest income increases by just 23 basis points. Return on assets is 14 basis points lower for Section 20 FHCs than for Section 20 BHCs, and return on equity dips by nearly 2.5 percentage points. Finally, the efficiency ratio at Section 20 FHCs is a statistically insignificant 140 basis points higher than the ratio at Section 20 BHCs, suggesting that the Section 20 FHCs did not experience cost advantages after becoming FHCs.

In sum, the effects of the Gramm-Leach-Bliley Act on Section 20 FHCs are modest, but certainly larger than the effects on other FHCs. Although Section 20 FHCs do not appear to be more profitable or cost effective than other FHCs, the former do appear to be repositioning themselves to exploit presumed synergies between investment banking and commercial banking.

Some anecdotal evidence indicates that these synergies are developing. A recent *New York Times* article documented the relative decline of two stand-alone investment banks—Merrill Lynch and Morgan Stanley—relative to the investment banks that are part of banking organizations such as Citigroup and JPMorgan Chase.[5] An integrated investment bank is able to provide its customers with a broad range of services that stand-alone investment banks cannot match.

Whether Gramm-Leach-Bliley will affect the viability of the stand-alone investment bank in the long run is not clear. What is clear is that the act to date has not caused a financial revolution; rather, it has contributed to the deregulation of financial markets and institutions within the United States with remarkably little impact.

Conclusion

One justification for the Gramm-Leach-Bliley Act of 1999 was to provide new opportunities to financial institutions to exploit revenue opportunities and cost savings by becoming universal banks. We fail to find evidence, however, that FHCs were able to capture significant and immediate benefits from this legislation.

These results should not be construed as evidence that the act was a step in the wrong direction. Rather, the act is a further step in the evolutionary process of financial deregulation that gives financial institutions more flexibility to adapt to their global environment. Indeed, our results are consistent with the view of Philadelphia Fed President Anthony Santomero, who wrote in 2001 that financial modernization is not a single event or law, but rather a relentless process of eroding the constraints placed on the financial marketplace during the Great Depression. Perhaps the short-run synergies between commercial banking, investment banking and insurance are modest, but the long-term synergies may be much larger.

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ENDNOTES

1. See Anason (1999) and Zaretsky (2000).
2. This article summarizes research by Yeager et. al (2005). Refer to the full paper for more details.
3. Although FHCs are technically also BHCs, we treat these groups as mutually exclusive. The data include all top-tier domestic banking organizations that file the Federal Reserve's FRY-9C—the Consolidated Financial Statements for Bank Holding Companies. By including only top-tier organizations, we avoid double counting parent companies and their subsidiaries. Mandatory Y-9C reporters include all domestic BHCs and FHCs with total consolidated assets of at least $150 million. Smaller organizations are omitted from this sample.
4. The statistical technique employed is a fixed-effects panel regression.
5. See Thomas (2004). The animation studio DreamWorks proved a specific example of how JPMorgan Chase was able to use its bank relationship with the firm to win the investment banking business.

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UP, UP and AWAY

Personal Bankruptcies Soar!

By Thomas A. Garrett
and Lesli S. Ott

Bad credit? No Credit? Bankruptcy? No problem. So go the large number of ads placed by businesses that cater to the financially overextended. Such ads are an example of the evolving view that bankruptcy is seen as an acceptable alternative to continued financial hardship. As evidence of our growing bankruptcy culture, personal bankruptcy filings in the United States increased from 1.2 per 1,000 people in 1980 to over 5.4 per 1,000 people last year, an increase of nearly 350 percent.[1] In terms of annual growth, personal bankruptcy filings per 1,000 people have been growing at an average rate of nearly 7 percent, about 1.5 times greater than the average rate of annual per capita GDP growth.

These statistics, however, disguise the fact that personal bankruptcy filings are not equal across the country. For example, at the state level, Tennessee had the highest rate of personal bankruptcy filings in the nation, with over 10 filings per 1,000 persons last year—nearly twice the U.S. rate—whereas Massachusetts ranked last with 2.8 filings per 1,000 people.

Explaining Bankruptcy

Researchers have found that the primary cause of personal bankruptcy is high levels of consumer debt often coupled with an unexpected insolvency event, such as the loss of a job, a major medical expense not covered by insurance, divorce or death of a spouse.[2]

Lower-income individuals are more likely to file for bankruptcy in response to an insolvency event, given their relatively limited access to financial counseling and fewer and less-diversified financial resources. The typical bankruptcy filer is a blue collar, high school graduate who is the head of a household in the lower middle income class with heavy use of credit, according to consumer economists' surveys.[3]

Several studies point to the decline in the social stigma related to bankruptcy as being partly responsible for the increase in filings. Also, the Bankruptcy Reform Act of 1978 is seen as an impetus for the record levels of bankruptcy filings in the 1980s and early 1990s.[4] This law relaxed asset exemption levels and made it easier for individuals to file for bankruptcy.

The rise and spread of casino gambling since the early 1990s also has been considered to be responsible, in part, for the rise in bankruptcies. However, the research on casino gambling and personal bankruptcy is mixed.[5] The research that does find a positive effect of casino gambling on bankruptcy rates usually finds that this effect is localized and very small—much smaller than the effect from the aforementioned factors.

Research suggests that bankruptcies may actually increase during periods of economic growth rather than during economic downturns.[6] For example, personal bankruptcies have grown over the past 25 years in the presence of relatively rapid income growth. In addition, consumer debt as a percentage of disposable personal income has risen from 11.1 percent in 1980 to over 13.1 percent last year.

Bankruptcy levels rise during times of economic growth as people become more confident in the future and are willing to take on a greater debt burden and finance their increasing obligations based on current income. However, as the supply of credit inevitably begins to tighten and interest rates and loan repayments begin to rise, the financial strain can become quite large. When this strain is coupled with an unexpected negative shock to income, an individual no longer has the ability to maintain the financial obligations undertaken in a time of economic exuberance.

Thus, although lower-income individuals may be more likely to file for bankruptcy in response to a negative income shock, income growth over time also creates the possibility that individuals may become financially overextended and, thus, see bankruptcy as a solution.

Bankruptcy Law

Debtors filing for personal bankruptcy protection may do so under two types of structured plans, Chapter 7 or Chapter 13. Under Chapter 7, a debtor is required to liquidate all nonexempt assets and have them distributed among his creditors as partial or full debt repayment.[7] Examples of exempt assets include equity in a home (called a homestead exemption) and 401(k) funds. In a relatively short time after liquidation, the debtor is forgiven the outstanding balance of his unsecured debts (remaining credit-card debt, for example). Under Chapter 13, in lieu of an asset liquidation, a debtor consents to a three- to five-year payment plan whereby he pays down a portion of his unsecured debts and is then forgiven the remaining balance. Under both plans, particular types of debt—such as government-backed student loans, child support and alimony payments, and recent income taxes—are ineligible for forgiveness and must be repaid. The overall trend has consistently been that over two-thirds of filers choose Chapter 7.

The federal government has recently implemented a policy aimed at reversing the increasing trend in personal bankruptcy filings that has occurred since the passage of the 1978 act. On April 20, 2005, President Bush signed the Bankruptcy Abuse Prevention and Consumer Protection Act, which is the most sweeping bankruptcy reform legislation passed in over 25 years. Previously, most major pieces of bankruptcy legislation slightly favored the consumer (debtor) over creditors. However, the 2005 act makes filing for bankruptcy more difficult through income-means testing, tougher guidelines for the homestead exemption, increased lawyer liability and required credit counseling.

Eighth District States vs. the Nation

The table provides a comparison of personal bankruptcy filings in Eighth District states with average bankruptcy filings in other states. Of the Eighth District states, Tennessee had the greatest number of filings per 1,000 people last year (10.5) and Illinois had the lowest (6.3). On average, Eighth District states had a filing rate of 7.7 per 1,000 people compared to an average filing rate of 5 per 1,000 people in other states. Thus, on average, states located in the Eighth District had roughly 2.7 more individuals per 1,000 filing for personal bankruptcy.

Although Eighth District states have a relatively higher rate of bankruptcy filing, the annual average growth in bankruptcies in the District since 1980 has been slightly lower than that of other U.S. states—7.2 percent vs. 7.8 percent. Within the District, Arkansas had the highest average annual growth rate (10.8 percent) and Illinois had the lowest (6.1 percent). Although Tennessee had the highest rate of bankruptcy of all District states (and the nation) last year, the average annual growth in bankruptcies in Tennessee was less than that in most other Eighth District states.

The table also shows that Eighth District states had an average per capita income that was nearly $3,000 less than other U.S. states' last year and an unemployment rate that was 0.6 percentage points higher than other U.S. states'. Comparing these data with the bankruptcy data suggests both per capita income and unemployment have a negative relationship with personal bankruptcy filings.[8] Note, however, that while Tennessee had a higher bankruptcy filing rate than other states did, it had per capita income that was higher than that of most other Eighth District states. Although a definitive causal relationship can be determined only by more rigorous statistical methods, the negative correlation is supportive of the finding that, at a given point in time, lower-income individuals may be more likely to file for bankruptcy, given relatively less financial literacy and less diversification of fewer financial assets.

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Personal Bankruptcies and Demographics Eighth District and U.S.

	Bankruptcies per 1,000 people 2004	Average annual percent change 1980 to 2004	Per capita income ($) 2004	Unemployment rate (%) 2004
Arkansas	8.6	10.8	25,725	5.7
Illinois	6.3	6.1	34,351	6.2
Indiana	8.8	7.3	30,094	5.2
Kentucky	7.0	6.7	27,709	5.3
Mississippi	7.2	8.7	24,650	6.2
Missouri	6.5	8.5	30,608	5.7
Tennessee	10.5	7.1	30,005	5.4
Eighth District states	7.7	7.2	30,560	5.7
U.S. excluding Eighth District	5.0	7.8	33,317	5.1
U.S. total	**5.3**	**7.6**	**32,937**	**5.5**

NOTE: Bankruptcy data are from the Administrative Office of the U.S. Courts, and demographic data are from the U.S. Census.

ENDNOTES

1. Bankruptcy data are from the Administrative Office of the U.S. Courts. See www.uscourts.gov/adminoff.html.
2. See Gropp et al. (1997), Buckley and Brinig (1998) and Nelson (1999).
3. See Shephard (1984).
4. See Domowitz and Eovaldi (1993).
5. See Nichols et al. (2000) and Thalheimer and Ali (2004).
6. See Eckstein and Sinai (1986) and Clark (1997).
7. See www.bankruptcydata.com and www.bankruptcyinformation.com for a comprehensive overview of bankruptcy laws and procedures.
8. The correlation between per capita income and bankruptcy filings is –0.18, and the correlation between filings and the unemployment rate is –0.55.

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The Economics of Charitable Giving

What Gives?

By Rubén Hernández-Murillo and Deborah Roisman

Generosity is a long-standing American tradition, one that continues to grow. The Giving USA Foundation estimates that Americans gave $248.5 billion to charity last year, a threefold increase in inflation-adjusted terms since 1964. To put the size of the donations in perspective, Americans gave to charity last year an amount roughly equal to the national incomes of Norway or Indonesia.[1] The most important source of giving is, not surprisingly, contributions from private individuals, which represent more than 75 percent of the total. The second most important source of contributions is foundations, and in third place, bequests.

What motivates people to give? Who gives? What is the price of giving? Why do people volunteer time to charitable activities? Economists have found some answers to these questions, but they have just started to model philanthropy as a market. As they do so, they are trying to analyze not only the strategic behavior of donors, but also the strategic behavior of charities. They are viewing charities as firms that hire inputs to produce goods and services. Competition among charities for private donations is also being examined, as are the interactions between the supply and demand for giving. Then there's the role of the government: It often provides charitable organizations with grants that are financed by income taxes. Do these grants displace donations from private individuals—the "crowding out" hypothesis—and, if so, to what extent?[2]

All of this is important for the design of public policy and for assessing how efficient charities are at providing the services they offer, such as alleviating poverty or funding cancer research.

Motivations for Giving

Why do people give? Studies overwhelmingly suggest that people are not entirely altruistic when giving. Individuals seem to derive more benefits from the act of giving itself than from the benefits that their gifts generate for others. The nature of these benefits, however, is not very clear. Donors may care about the total amount of goods or services that charities produce, or donors may enjoy the simple act of giving. Individuals may also care about the public recognition they receive from giving.

Perfect Altruism

Under the theory of "perfect altruism," donors are concerned primarily that charities receive some total amount of money, regardless of the sources. An individual donor is indifferent between giving a dollar to a charity and the charity's receiving the dollar from someone else. For example, if a donor thinks that a particular charity should receive a total of $1,000 from all sources to meet its needs, and the donor estimates that other sources will provide $900, he will donate the remaining $100. If, instead, the donor estimates that other sources will provide $1,000 or more in total, he will not give anything to that charity.

One implication of the perfect altruism model is that individual donations can be completely "crowded out" by government contributions. Using the example above, if the government taxes the donor $10 and hands it over to the charity, the donor will simply reduce his contributions to the charity by $10. For the charity, the net effect of the government donation is zero.

This theory, however, has several implications that are not validated by the empirical evidence on private charities. Studies have found that the crowding out is only partial at most.[3] Why? Because donors get more satisfaction out of giving a dollar directly to charity than they do out of seeing a dollar of their tax money go directly to that same charity. They want to contribute on their own.

The "perfect altruism" theory also seems to fall apart when the number of potential donors is large. Economist James Andreoni and others established in the 1980s that the theory would imply that individuals would not try to anticipate what everyone else is giving because the gift of any one donor would be small relative to the total. The contributions of most donors, then, would fall toward zero, except for the donations from the very rich, who, because of the size of their contributions, would maintain some control over the total amount raised. But the data don't support this scenario. They show, instead, that people from all income levels continue to give.

The Warm Glow

Andreoni and others have come up with alternative theories for why people give to charity. One is the "warm glow" theory, by which donors derive an internal satisfaction from giving, although their contributions may be entirely anonymous. Under this theory, donors view the gifts of others as imperfect substitutes of their own contributions. That is, they would prefer that gifts come from themselves rather than from others. This, too, implies that the crowding-out from government grants will not be complete. The reason is that voluntary contributions and involuntary giving through taxes are not equivalent in people's minds; consequently, government taxation does not reduce private contributions by the same amount.

Prestige

Yet another model comes from economists Amihai Glazer and Kai Konrad. They say the data show that donors give, at least partly, to signal wealth status and not just because they obtain internal satisfaction. Economist William Harbaugh further realized that when the names of donors are publicly announced and the gift amounts are given in categories (gifts of $500 to $999 to qualify as "sponsor," $1,000 to $1,999 to qualify as "patron," etc.), most contributions are exactly the minimum amount required for inclusion in each category. Preference for prestige implies that charities can increase contributions by reporting gift categories and publicizing donations.

Who Gives?

Although several demographic characteristics have been found useful in predicting charitable giving, income is by far the most important predictor of giving behavior, according to economists Robert McClelland and Arthur Brooks. Giving as a function of income has a U-shaped pattern—people in the lowest and highest income groups give larger proportions of their incomes to charity than individuals in middle-income groups. A plausible explanation for this is that people in lower-income groups tend to give more to religious organizations, while people in higher-income groups simply have more disposable income. (Interestingly, very rich people give almost nothing to religious charities.) McClelland and Brooks find that this U-shaped pattern persists even when accounting for additional variables associated with income. This relationship with income implies that the philanthropy industry will continue to thrive as the economy prospers.

Charitable giving also increases with age and education; it varies, too, with respect to sex (women give more) but not with race.[4]

The Price of Giving

The fact that charitable donations can be deducted from taxable income implies that the richest individuals, who face the highest marginal tax rate, have the greatest incentive to donate because they face the lowest marginal cost of giving. (For them, charitable giving carries with it the highest effective subsidy.) In other words, for an individual facing a marginal tax rate of 30 percent, the price of a dollar given to charity is 70 cents; the remaining 30 cents are paid by the government in taxes foregone, hence the subsidy. (Note that someone who does not itemize deductions effectively pays a price of one dollar for each dollar of giving.)

Giving Time or Money

Individuals often volunteer time to charitable activities. Andreoni explains that if individuals were perfectly altruistic, we should observe little volunteering. Why? Volunteering time implies an opportunity cost to individuals, as they could work and be paid elsewhere and instead give some of those wages to the charity. Charities value volunteer services at the market wages they would have to pay to hire labor services. Presumably, the opportunity cost of volunteers is higher than this imputed wage because people only volunteer to do work for which they are overqualified. If individuals were perfectly altruistic and cared only about the total value of their monetary contributions plus imputed wages for their time, they would prefer to work elsewhere for pay and contribute money to the charity. This implication is not validated by the evidence. People do volunteer their time to charitable activities. Thus, Andreoni concludes, it is best to think of volunteering as having some independent warm glow component as well.

What Gives?

Although some people may be altruistic when giving, economics tells us that the dominant motivation is the internal satisfaction that individuals derive from the act of giving itself. Individuals derive utility from giving much in the same way they obtain satisfaction from buying a new car or eating at a restaurant; especially when the number of donors is large, the social context of other people's giving is overshadowed by the satisfaction of one's own giving when considering how much to give.

Rubén Hernández-Murillo is a senior economist, and Deborah Roisman is a senior research associate, both at the Federal Reserve Bank of St. Louis.

ENDNOTES

1 See www.worldbank.org/data/databytopic/GNI.pdf.
2 For a more thorough review of the literature, see Andreoni (forthcoming).
3 For example, see Steinberg (1989).
4 See Yen (2002), Andreoni and Vesterlund (2001), and Rooney et al. (2005).

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Ducks and Rice Are Staples in Stuttgart

By Glen Sparks

Every fall, as the air gets cool, the ducks head to Stuttgart. Flocks fly near the giant grain silos just west of downtown.

Stuttgart, a city of about 9,400, calls itself the "duck and rice capital of the world." Hard clay underneath the topsoil makes this area ideal for growing rice. The place also seems ideal for migratory birds escaping the cold in Canada. The city lies on the Mississippi flyway, near the meandering Arkansas and White rivers. The Bayou Meto and several lakes make the Stuttgart region that much more inviting to waterfowl. Ducks also like to gobble up any remains from the summer harvest of rice.

As the ducks flock to Stuttgart, so do hunters from across the country and world. Among the "big names" who come to hunt are Vice President Dick Cheney and Dallas Cowboys owner Jerry Jones, say city officials.

"We really don't need to advertise the duck hunting here," says Stephen Bell of the Chamber of Commerce. "It's pretty much on reputation. There are times it seems like the whole town is in camouflage."

The duck hunting season adds $1 million a day to the Stuttgart economy, says Bell. That's quite a chunk for a city whose budget last year was just $10.7 million. That's why city leaders keep their fingers crossed that there will be enough ducks for a full 60-day season every year.

To kick off the season, Stuttgart throws a big party during the week of Thanksgiving. Crowds fill the downtown streets to celebrate the Wings Over the Prairie Festival and the World Championship Duck Calling Contest. The city even holds a Queen Mallard Pageant. The local chamber organizes the festival, which last year cost about $370,000 and netted a $135,000 profit. "It's better than a bake sale," Bell jokes.

Many hunters pursue their quarry at one of the approximately 70 commercial and private duck clubs that lie within a 45-mile radius of Stuttgart. Farmers and duck-club owners use pneumatic tubes to flood acres of fields and timberland to lure the ducks for the hunters.

When the hunters are not sitting in duck blinds, they gather at Mack's Prairie Wings, a business on the edge of town that is dedicated to serving waterfowl hunters. What started as a small store downtown in 1944 has grown into retail and warehouse space that's almost as big as two football fields. Mack's does so much business that Winchester Ammunition of East Alton, Ill., has named it the No. 1 steel shot dealer in the world for seven straight years.

Fueling the boom was the addition of a mail-order catalog business in 1993.

"We went from being a state-wide company to being a national company when we began publishing the catalog," says Deena Fischer, a spokeswoman. This year, 1.8 million catalogs will be mailed out.

Stuttgart's economy doesn't depend solely on the great outdoors. Lennox Industries, for example, employs 910 in making commercial heating and air-conditioning units. Lennox is big enough that suppliers are opening up shop nearby. In late July, Assembly Component Systems Inc. opened a new plant in Stuttgart and hired 11 workers. The Kansas-based supplier makes fasteners for Lennox air conditioners. Two other suppliers also have opened up shop near Lennox: Scott Manufacturing Inc. and Industrial Crate and Supply Co.

Tim Walker, a Lennox executive, says he hopes Lennox can attract more suppliers to Stuttgart.

"Agricultural communities like this are full of talented, skilled workers who fit in well with heavy manufacturing jobs," Walker says. "Plus, when suppliers move close to us, we save money on travel costs and it frees up space for us. We don't need to keep as much inventory."

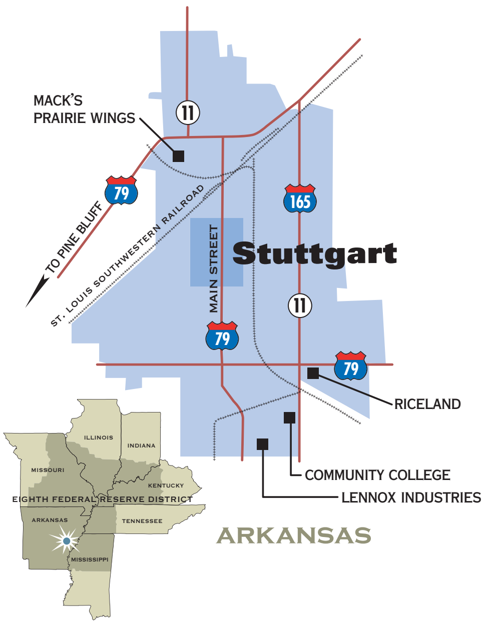
Downtown Stuttgart is a mix of mom-and-pop shops. Brenda Dickson, a third-generation florist, owns Fern and Feather. Business goes up and down, she says.

"This is a farming community," Dickson says. "If the economy does well, our store does well. Stuttgart is probably like just about every other small Southern town. We were hurt by Wal-Mart and other discount stores."

The Arkansas Department of Parks and Tourism hopes that Stuttgart's fowl reputation can sprout some new wings. State officials want the city to promote itself also as a bird-watching hub.

"It'd be kind of odd, though," Bell says. "People come in to kill ducks, but now we'd be asking them to come and watch them."

Glen Sparks is an editor at the Federal Reserve Bank of St. Louis.



Stuttgart, Ark.

BY THE NUMBERS

Population	Stuttgart 9,377 (2004) Arkansas County 20,130 (2004)
Labor Force	Arkansas County 11,584 (May 2005)
Unemployment Rate	Arkansas County 6.3 (May 2005)
Per Capita Personal Income	Arkansas County $26,489 (2003)

Top Five Employers

Riceland Foods Inc.	1,025
Lennox Industries	910
Producers Rice Mill Inc.	425
Kinder-Harris Inc.	102
Rice Capital Inc.	97

Rice Industry Stands Tall in Stuttgart

In a town where some cars sport "Have a Rice Day" bumper stickers and grain silos dominate the skyline, it's not surprising to hear Bill Reed say that rice "is why Stuttgart is here."

Reed is a spokesman for Riceland Foods Inc., which is not only the biggest employer in town but also the biggest rice miller in the world. It employs 1,025 in Stuttgart. Two other millers employ another 500 or so.

"It'd be hard to come to Stuttgart and find a family that does not include at least one person who works in the rice industry," says Reed.

W.E. Hope was the first farmer to grow rice in Stuttgart, on a 9-foot by 27-foot plot of land in 1901. Hope apparently had noticed the dense layer of clay that rests beneath the prairie topsoil. The hard clay was ideal for holding water. Rice grows best in flooded fields.

Arkansas harvests 41 percent of the nation's rice, almost twice as much as No. 2 California (21 percent). Riceland alone is responsible for almost one-third of the U.S. crop.

Local farmers founded the Riceland cooperative in 1921 to get better prices. Today, 9,000 farmers belong. Forty of them sit on the board of directors.

The average Riceland farm is about 750 to 1,000 acres, Reed says. About one-third to one-half is devoted to rice, with the rest going to soybeans, one of the other crops Riceland processes. The number of rice farmers in the area is dwindling, Reed says, but the typical farm is getting bigger as technology improves and the agricultural industry looks for ways to cut costs.

"Labor is part of the issue," Reed says. "There isn't much available. Therefore, farm equipment is getting bigger and faster to make up the difference."

After farmers thresh their rice with combines, they deliver the crop to Riceland, which dries it, stores it, transports it, processes it, markets it and pays the farmers.

Riceland sells about $1 billion worth of product every year from Stuttgart, with the rice and oil products going out across the nation and to 75 cities abroad. The rice itself is packaged in bags ranging from four ounces to 2,000 pounds.

A few years ago, after the Bush administration lifted certain trade restrictions, Riceland began shipping rice to Cuba. Iraq is emerging again as a major market. Mexico, Haiti, Saudi Arabia and Europe also buy Riceland rice in bulk.

"About 95 percent of the rice that is grown in the world stays in that area," Reed says. "China and India, for instance, are big rice producers. For us, though, the export market is very important."

Stuttgart lies in the richest rice-growing area in the United States. Riceland is the city's largest employer and the biggest rice miller in the world.

Ducks Mean Big Business

Hunters enjoy Wildlife Farms almost as much as the ducks do. Waterfowl head to Wildlife Farms every fall and hang out near the White River or on one of the many Wildlife lakes. Hunters pay $550 a day to bag a duck or goose. That price includes the guided hunt, a heated blind for duck hunting, plus lodging and meals.

Wildlife Farms is one of about 70 private and commercial duck clubs within an hour's drive of Stuttgart. The duck clubs help prop up the economy in a part of the country that is struggling to gain new industry, says Jeff Collins, director of the Center for Business and Economic Research at the University of Arkansas. Club owners usually lease land from farmers during the fall and winter, Collins says.

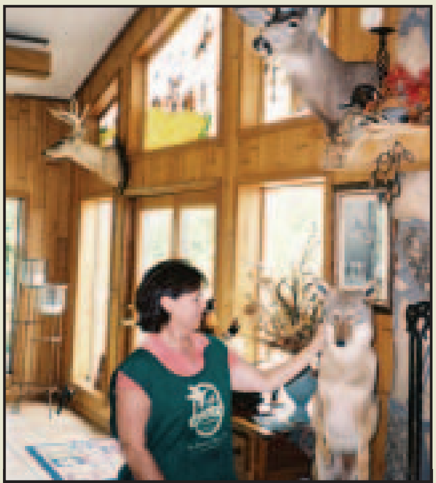
"Duck hunting is a part of the social network in this part of the country," Collins says. "Duck hunting is booming. It's natural to think that duck clubs also are booming."

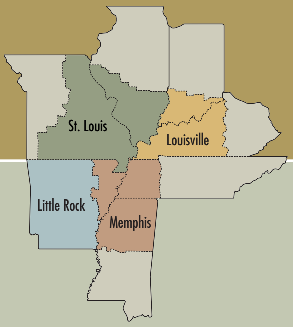
Waiting lists can be long to join some private duck clubs, Collins says. He is 30th on a waiting list for a club that has just 20 or so members.

Sally and Dan Barnett established Wildlife Farms in 1992 just a few miles east of Stuttgart. The couple built a 12,000-square-foot lodge that overlooks Clear Lake. Sally Barnett runs the business day to day, while her husband continues to work as a stockbroker in Little Rock.

Wildlife Farms stays busy all year. Guests fish for bass, catfish and crappie in the summer. Spring is a popular time for company retreats and business meetings. Wildlife Farms added a 3,000-square-foot conference center in 2000 that can handle up to 120 people for day meetings and 66 people for overnight visits. The lodge also is a popular place for weddings, receptions and family gatherings.

Business booms in the fall and winter. Hunters come from as far away as the Philippines and Argentina to Wildlife Farms in quest of deer, turkey, pheasant, partridge, but most of all, duck. By mid-September, rooms at the lodge are full. They stay that way until mid-February.


After hunting on more than 1,750 acres, visitors to Wildlife Farms can relax in a lodge that features a wet bar, game room, computer room and a hot tub overlooking Clear Lake. Sally and Dan Barnett built this duck hunting club in 1992.



District's Largest Urban Area Slowly Regains Jobs Lost during Recession

By Elizabeth A. La Jeunesse and Christopher H. Wheeler

Although the most recent U.S. recession officially lasted from March to November 2001, employment in the St. Louis metropolitan area continued to fall through much of 2002 and 2003. According to the payroll survey conducted by the Bureau of Labor Statistics, St. Louis' total nonfarm employment declined by more than 32,000 or nearly 2.5 percent between March 2001 and December 2003. Following a period of relative stability in the first half of 2004, St. Louis' labor market subsequently expanded. During the latter half of 2004, the metropolitan area gained 9,000 jobs. Positive employment growth continued into this year; between January and July, St. Louis gained another 6,000 jobs.

Gainers and Losers

Despite the net drop in total employment since March 2001, two sectors in St. Louis have registered sizable employment gains over the past four years: education and health services, and leisure and hospitality. Since March 2001, employment in the education and health services sector has increased by 8 percent or slightly more than 15,000 jobs. This pattern followed the national trend in which education and health services employment increased by more than 12 percent over the same period. Between March 2001 and July 2005, St. Louis' leisure and hospitality sector experienced employment growth of over 6 percent or nearly 8,500 jobs. This increase owes primarily to growth in the accommodation and food service industry, as hotels, motels, and eating and drinking establishments added over 6,500 jobs.

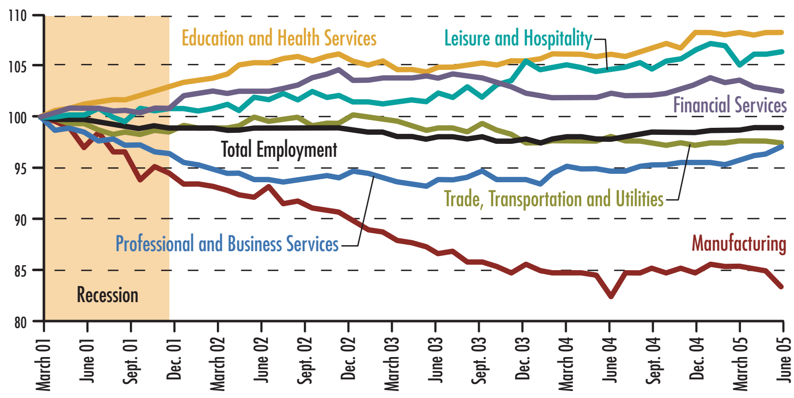
Employment has also grown within St. Louis' relatively smaller financial services industry, which includes banks, security brokers and insurers, as well as jobs in real estate. Since March 2001, nearly 2,000 financial services jobs have been added to the metropolitan area's payrolls.

Underlying much of St. Louis' net job loss since March 2001 are losses in three major sectors: manufacturing; professional and business services; and trade, transportation and utilities. Manufacturing, by far, has experienced the deepest job losses in the metropolitan area over the past four years. Collectively, St. Louis manufacturers eliminated more than 25,000 jobs or roughly 15 percent of their payrolls between March 2001 and July 2005. Nationwide, manufacturing employment declined by more than 15.5 percent over the same period.

Although not as large, job losses in the professional and business services sector numbered approximately 6,000 over this period. Trade, transportation and utilities lost an additional 6,500 jobs due primarily to declines in transportation and utilities rather than wholesale and retail trade.

Employment in the St. Louis Metropolitan Area

March 2001=100, seasonally adjusted



SOURCE: Bureau of Labor Statistics

Reversing Roles

During the first half of this year, the primary job growers of the past four years have begun to slow. Payrolls in both leisure and hospitality and education and health services have been relatively flat since the beginning of the year.

Two of the major job losers since March 2001, by contrast, have begun to show some new life. Since January 2005, the professional and business services sector has recovered, gaining more than 4,000 jobs in the past 12 months, 3,000 of which have been added since January. Modest gains have also been seen in trade, transportation and utilities, although much of this is associated with stabilization in the transportation sector combined with gradually expanding employment in wholesale and retail trade. More than 400 jobs have been added in the trade, transportation and utilities sector since January.

Recovering Slowly

Recent trends indicate that employment in St. Louis appears to have turned a corner. Although still 14,000 jobs short of its March 2001 peak level, St. Louis has nonetheless shown steady job growth for much of the past year. In the past six months, most major sectors have either stabilized or begun to expand. All of this points to a labor market that is slowly, but gradually, strengthening.

Elizabeth A. La Jeunesse is a research associate, and Christopher H. Wheeler is a senior economist, both at the Federal Reserve Bank of St. Louis.

LITTLE ROCK

Fayetteville and Hot Springs Lead the Recovery in Employment

By Giang Ho and Anthony Pennington-Cross

Among the five metropolitan statistical areas (MSAs) outside Little Rock-North Little Rock, only Fayetteville-Springdale-Rogers experienced job increases (3.2 percent annual on average) both during and after the 2001 recession. Employment in Hot Springs, a newly classified metropolitan area, has also recovered well from the recession, growing at a solid annual rate of 2.5 percent since March 2002. However, the remaining MSAs (Fort Smith, Pine Bluff and Texarkana) have undergone a "jobless recovery," where labor market performance has remained dismal despite an improving economy. These disparate employment trends characterize the changing economic landscape in Arkansas.

The Fayetteville-Springdale-Rogers MSA is located in the Ozark region—the extreme northwestern upland portion of Arkansas—and consists of three Arkansas counties, Benton, Washington and Madison. It lacks the Delta's rich soil and the industrial base of the state's centrally located capital, and only 50 years ago was the poorest area of the state. The economic wheel began turning and picking up speed when several entrepreneurial and ambitious Arkansans started building world-class companies in Ozark towns—Don Tyson's Tyson Foods Inc. in Springdale and Sam Walton's Wal-Mart Stores Inc. at Bentonville, among others. By the 1990s, the MSA's population was growing rapidly (47.5 percent between 1990 and 2000), and jobs were being created at an even faster rate.

Employment growth in the Fayetteville MSA since the recession has been uniformly strong in almost all sectors. Except for a slight decline in manufacturing, which was still mild compared to Arkansas' decline as a whole, job creation has been particularly strong in the natural resources, mining and construction sector (36 percent from March 2001 to June 2005), education and health services (24 percent), and the trade, transportation and utilities sector (21 percent). Between June 2004 and June 2005, Fayetteville added 13,675 workers, more than 1,000 workers per month. Some of this gain came from unemployed people getting jobs, but most was due to emigration from other parts of Arkansas or from other states.[1] The unemployment rate in Fayetteville stood at 3.4 percent in June, the lowest in the state and well below the national average of 5 percent.

On the other hand, in the remainder of the zone and especially in central Arkansas, the post-recession employment recovery has been a mixed picture, including declining employment in **Pine Bluff,** stagnating employment in **Fort Smith, Pine Bluff** and **Texarkana,** and increasing employment in **Hot Springs**.

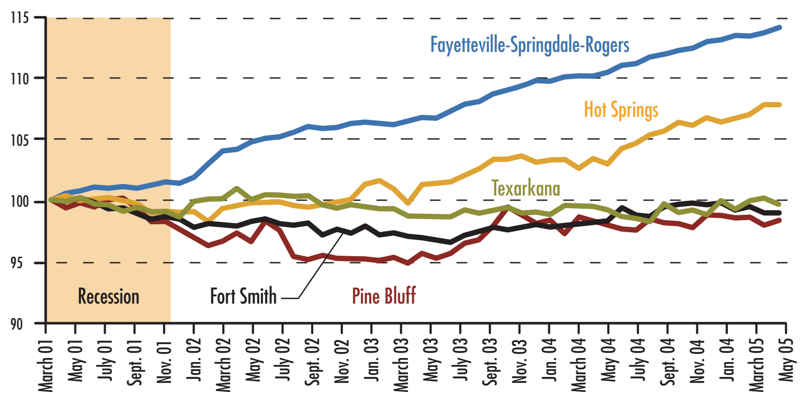
Hot Springs, which consists of only Garland County, has outperformed its neighbors, thanks to especially solid job increases in professional and business services (27 percent) and leisure and hospitality (25 percent). It was ranked No. 14 among the nation's MSAs that had the fastest job growth based on change in nonfarm payroll employment between June 2004 and June 2005.

In contrast, Fort Smith was hit especially hard in the financial activities sector, which has declined by more than 15 percent since March 2001. Texarkana also experienced a decline of over 7 percent in natural resources, mining and construction employment. However, increases in government employment of over 10 percent in both Fort Smith and Texarkana helped to counterbalance these declines. The employment outlook in Pine Bluff, which sits adjacent to Little Rock-North Little Rock, is equally bleak. Since March 2001, the metropolitan area has lost 35 percent and 15 percent of jobs in the information sector and the manufacturing sector, respectively. In June 2005, its unemployment rate of 7.3 percent was the highest in the state. On a more positive note, professional and business services grew over 27 percent.

Fayetteville still has some way to go, but if the present trends continue it may become the largest economic force in the zone. For example, Fayetteville's share in total Arkansas employment has increased from 11 percent to 17 percent in the past 15 years, with improvement in every sector.

Total Private Nonfarm Employment

March 2001=100, seasonally adjusted



SOURCE: Bureau of Labor Statistics

Giang Ho is a research associate and Anthony Pennington-Cross is a senior economist, both at the Federal Reserve Bank of St. Louis.

[1] Northwest Arkansas' News Source, July 20, 2005. See www.nwanews.com.

National Overview

Official Dates for Business Cycles
Don't Capture All the Ups and Downs

By Howard J. Wall

Those who want a complete picture of business cycles should look beyond the dates determined by the National Bureau of Economic Research for the starts and ends of recessions and expansions. The NBER's Business Cycle Dating Committee provides a good snapshot of the broad aggregate economy, but the committee's methodology overlooks other related business cycles that are also important.

Although the NBER determines recession dates by evaluating a variety of different measures of economic activity, the dates are closely aligned with movements of the broadest measure, gross domestic product. As is well-known, however, recent NBER recessions have not been in synch with periods of recession in the labor market. The NBER said the latest recession to hit the country started in March 2001 and ended in November 2001. According to a forthcoming study to be published by the St. Louis Fed, the U.S. labor market entered recession in May 2000—nearly a year before the start of the NBER recession—and exited recession in November 2003—a full two years after the end of the NBER recession.[1]

A second interesting characteristic of the business cycle that is missed by the NBER, and by anyone who focuses solely on national-level data, is the geographic pattern of state-level recessions and expansions.[2] The last two recessions, in particular, each had a strong geographic element. Many coastal states went into recession well before the NBER recession began in July 1990 and did not leave recession until well after the NBER recession ended in March 1991. The most recent recession had the opposite pattern: States in the middle of the country tended to enter recession earlier than the country as a whole and tended to be the states that exited recession later than the country as a whole.

The experiences of the seven states wholly or partly in the Eighth Federal Reserve District provide a good illustration of the diversity of state-level experience during the period surrounding the most recent recession.

Except for Illinois, every District state entered into labor-market recession earlier than the country did. Mississippi's recession began the earliest, in August 1999, nine months before the country's labor-market recession began and six months before Missouri's. At the other extreme, Illinois' labor-market recession began one month after the country's did, while those of the remaining states began one to three months before the country's.

District states can be separated into two distinct groups in terms of the dates by which they saw their final months of labor-market recession. Recessions in Arkansas, Indiana, Kentucky and Tennessee ended in either July or August 2003, several months before the end of the national labor-market recession. On the other hand, three District states did not see their labor-market recessions end until well after this date: Illinois did not see the end of recession until June 2004, while Mississippi and Missouri had to wait until July of the same year.

Although the national labor market experienced one uninterrupted period of recession between May 2000 and November 2003, two District states—Indiana and Mississippi—saw brief periods of expansion during their overall recession experience. Indiana's labor market saw a "double dip" in that it returned to expansion in May 2002, only to dip back into recession just four months later. Mississippi actually saw a "triple dip," exiting recession in April 2002 and July 2003, only to return to recession two and six months later, respectively.

The final column of the table indicates the total number of months that each state's labor market was in recession during the period surrounding the 2001 NBER recession. Illinois, Mississippi and Missouri were in recession for between seven and 11 months more than was the U.S. labor market, which was in recession for 42 months. In contrast, all of the other four District states were in recession for fewer months than the country as a whole.

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Labor-Market Recessions

	End of expansion period	End of final recession period	Number of recession periods	Total months of recession
Arkansas	March 2000	July 2003	1	40
Illinois	June 2000	June 2004	1	49
Indiana	March 2000	July 2003	2	36
Kentucky	April 2000	July 2003	1	39
Mississippi	August 1999	July 2004	3	51
Missouri	February 2000	July 2004	1	53
Tennessee	March 2000	August 2003	1	41
United States	May 2000	November 2003	1	42

[1] Owyang, Michael T.; Piger, Jeremy; and Wall, Howard J. "The 2001 Recession and the States of the Eighth Federal Reserve District." Federal Reserve Bank of St. Louis *Regional Economic Development*, Vol. 1, No. 1, 2005, forthcoming.

[2] Owyang, Michael T.; Piger, Jeremy; and Wall, Howard J. "Business Cycle Phases in U.S. States." *Review of Economics and Statistics*, Vol. 87, No. 4, November 2005, forthcoming.

National and District Data

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

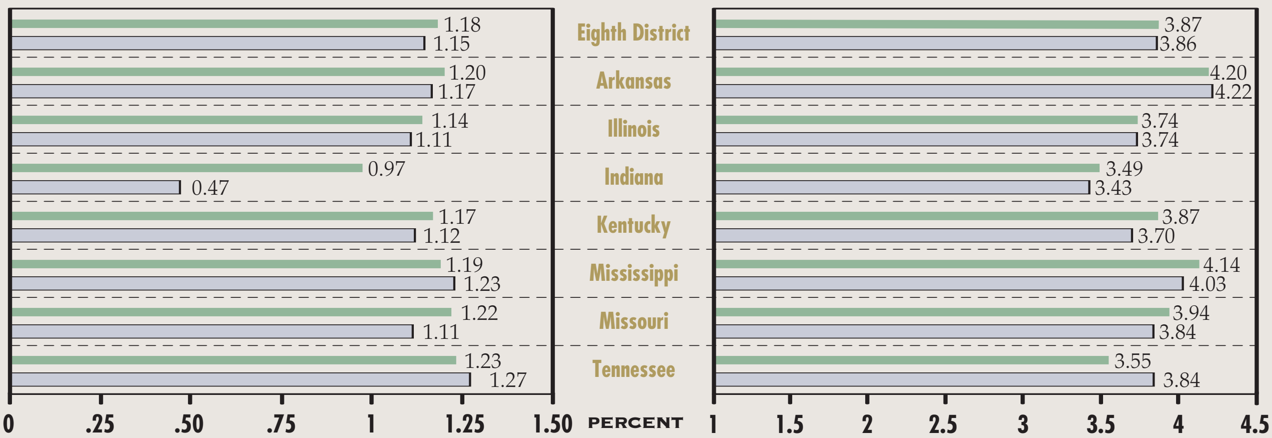
Commercial Bank Performance Ratios

SECOND QUARTER 2005

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*	1.35	1.26	1.19	1.37	1.27	1.42	1.35	1.35
Net Interest Margin*	3.60	4.32	4.32	4.24	4.28	3.83	4.05	3.41
Nonperforming Loan Ratio	0.78	0.70	0.76	0.65	0.71	0.62	0.66	0.83
Loan Loss Reserve Ratio	1.38	1.29	1.32	1.31	1.32	1.34	1.33	1.41

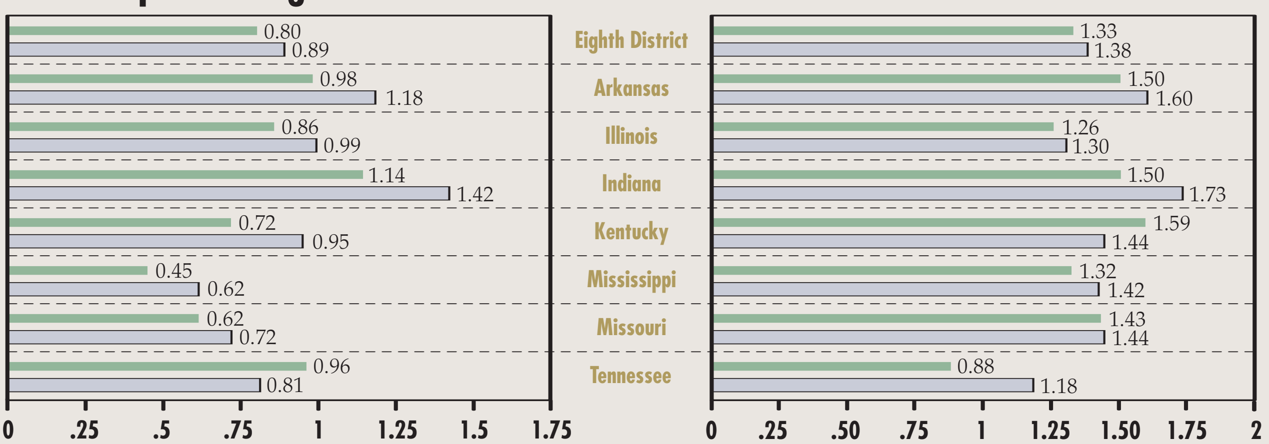
Return on Average Assets*

Net Interest Margin*



Nonperforming Loan Ratio

Loan Loss Reserve Ratio



Second Quarter 2005 Second Quarter 2004

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 2005

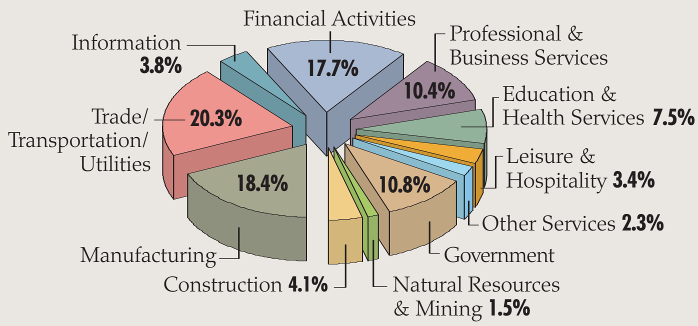
	UNITED STATES	EIGHTH DISTRICT	ARKANSAS	ILLINOIS	INDIANA	KENTUCKY	MISSISSIPPI	MISSOURI	TENNESSEE
Total Nonagricultural	1.6%	0.9%	1.1%	0.6%	1.2%	1.0%	1.0%	0.8%	0.8%
Natural Resources/Mining	6.2	2.2	5.2	–2.1	–0.5	3.6	–0.4	11.7	0.0
Construction	4.2	1.4	1.9	–0.2	2.4	3.8	1.6	1.2	1.9
Manufacturing	–0.3	–0.1	–0.8	–0.8	0.2	0.6	–0.3	0.7	–0.1
Trade/Transportation/Utilities	1.3	0.7	0.7	0.3	0.7	0.6	1.0	0.9	1.1
Information	0.1	–2.6	–0.7	–3.9	–1.3	–3.1	–0.5	–1.7	–2.9
Financial Activities	1.9	0.9	1.9	0.6	1.3	–2.5	1.5	2.3	1.5
Professional & Business Services	3.1	2.1	1.9	2.9	2.2	4.1	3.0	–0.4	1.1
Education & Health Services	2.3	1.8	2.6	0.8	2.9	1.2	3.0	2.0	1.9
Leisure & Hospitality	2.3	1.9	2.1	3.2	1.9	2.4	0.7	0.3	1.2
Other Services	0.8	0.4	–0.4	–0.5	2.0	1.4	–0.5	1.0	0.3
Government	0.7	0.2	1.7	–0.3	0.3	–0.1	0.8	0.6	0.0

Unemployment Rates

PERCENT

	II/2005	I/2005	II/2004
United States	5.1%	5.3%	5.6%
Arkansas	4.9	5.4	5.8
Illinois	5.9	5.7	6.2
Indiana	5.1	5.6	5.1
Kentucky	5.7	5.2	5.5
Mississippi	7.0	7.0	5.9
Missouri	5.5	5.8	5.6
Tennessee	6.0	5.9	5.4

District Real Gross State Product* by Industry–2003

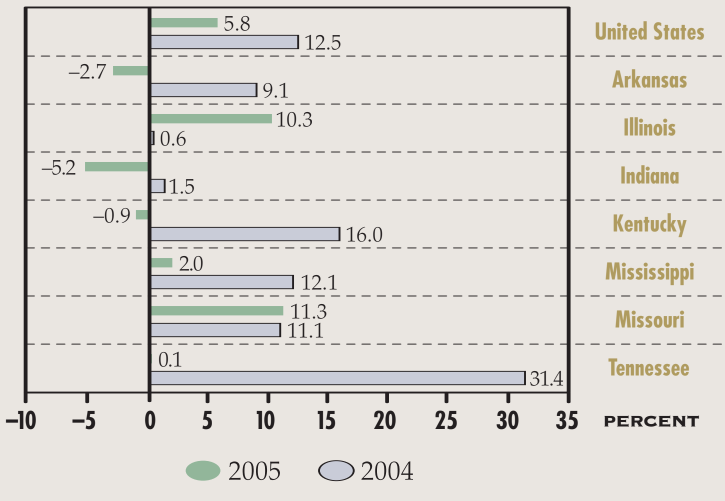


UNITED STATES	$10,289 BILLION
DISTRICT TOTAL	$1,301 BILLION
CHAINED 2000 DOLLARS	

SECOND QUARTER

Housing Permits

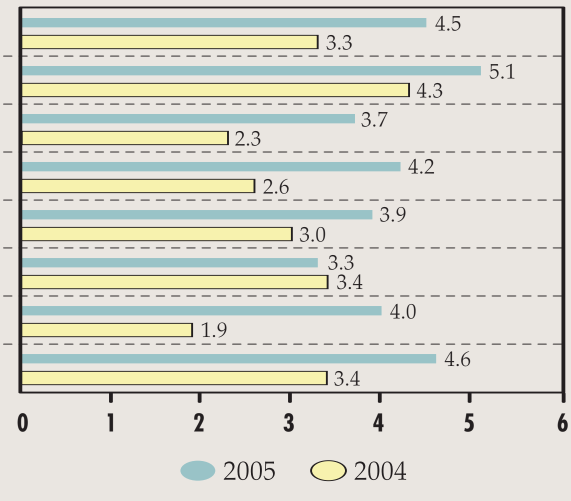
YEAR-OVER-YEAR PERCENT CHANGE IN YEAR-TO-DATE LEVELS



FIRST QUARTER

Real Personal Income†

YEAR-OVER-YEAR PERCENT CHANGE



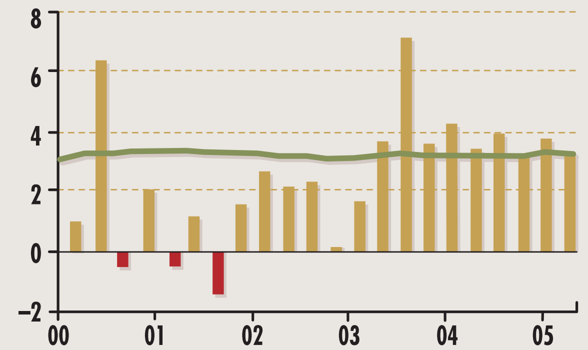
*NOTE: Data have been converted from the 1987 Standard Classification (SIC) system basis to a 2002 North American Industry Classification (NAICS) basis.

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

Major Macroeconomic Indicators

Real GDP Growth

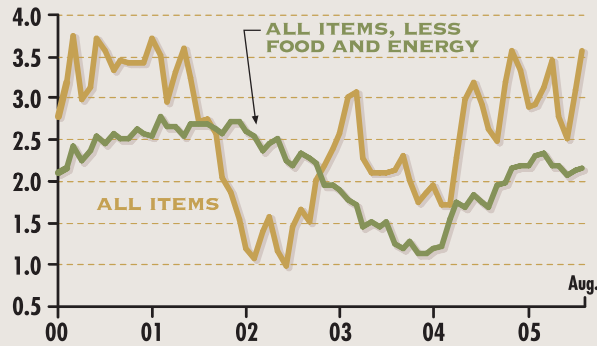
PERCENT



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

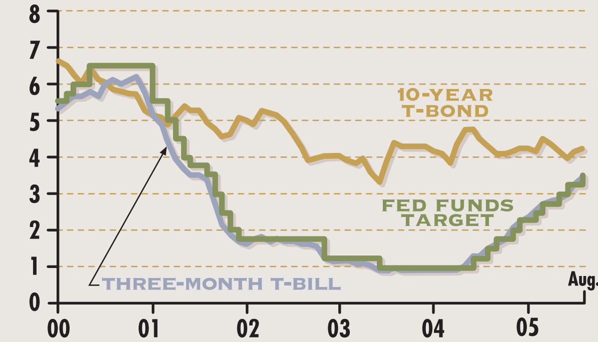
Civilian Unemployment Rate

PERCENT

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

Interest Rates

PERCENT

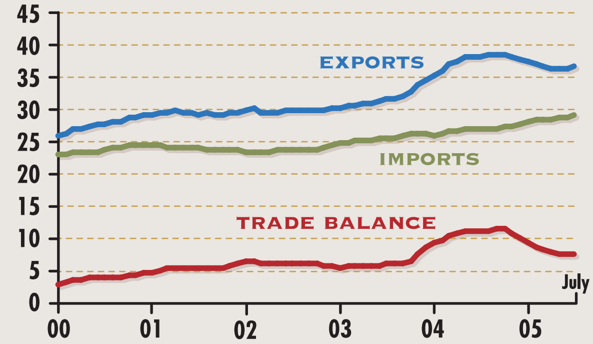


NOTE: Except for the fed funds target, which is end-of-period, data are monthly averages of daily data.

Farm Sector Indicators

U.S. Agricultural Trade

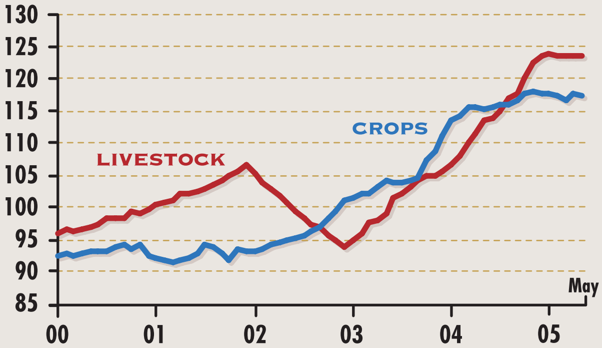
BILLIONS OF DOLLARS



NOTE: Data are aggregated over the past 12 months.

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