President's Message

"If ILCs were small, the matter would not be receiving so much attention. But the more than 50 FDIC-insured ILCs are now among some of the nation's largest and more complex financial institutions."

William Poole

PRESIDENT AND CEO,
FEDERAL RESERVE BANK OF ST. LOUIS

Wal-Mart Application Focuses Spotlight on Industrial Loan Companies

Wal-Mart has been in the spotlight in recent months for its application with the FDIC to obtain deposit insurance for an industrial loan corporation (ILC).

ILCs have been around for 100 years. For most of that time, they have been small, locally owned institutions with limited deposit-taking and lending powers. But that changed in 1987, when Congress passed an exception to federal banking law to allow any type of business to own an ILC. And since then, ILCs have been purchased by non-financial firms, including General Electric Co., Volkswagen A.G., General Motors Corp., Pitney Bowes Inc. and Target Corp.

So why are bankers and regulators concerned? Isn't the ILC supervised by the FDIC and the chartering states?

That's correct, but the corporation owning the ILC is not. To critics of the Wal-Mart application, this gap raises a number of concerns. Among them:

- Unintended extension of the federal banking safety net to commercial firms that own ILCs. Risks might be shifted to the federally insured ILC, yet the FDIC could not force the parent company to cover the losses of the ILC if it were to fail.
- The commercial firm may have business objectives that are not consistent with the safety and soundness of the insured ILC; and
- The commercial firm's market power might increase because of its ownership of the ILC.

If ILCs were small, the matter would not be receiving so much attention. But the more than 50 FDIC-insured ILCs are now among some of the nation's largest and more complex financial institutions, according to the Government Accountability Office. Assets topped $140 billion in 2004. The Merrill Lynch ILC by itself has more than $50 billion in deposits.

Wal-Mart argues that its ILC application is getting far more scrutiny than those already approved for GE, GM, Volkswagen and even its top competitor, Target. Wal-Mart has promised not to open retail branches in its stores and said the primary purpose of the new ILC would be to process credit- and debit-card transactions. By processing in-house the approximately 140 million electronic transactions its stores generate each month, Wal-Mart expects to realize considerable savings, which, as with all of its efficiencies, it would pass along to consumers.

But many bankers are not convinced; they fear that the wall separating banking from commerce will crumble. Retired Federal Reserve Chairman Alan Greenspan has agreed. Before leaving the Fed, Greenspan urged Congress to hold open, public discussions as to what is best to protect the safety and soundness of the banking system—and the taxpayers who ultimately pay for our mistakes. The new Fed chairman, Ben Bernanke, has agreed. In his first address to the House, Bernanke backed a measure that would put industrial loan companies under Fed oversight.

Public hearings planned by the FDIC will allow both proponents and opponents to present their views on this important matter. However it plays out, the issue of ILCs promises to be one of the more interesting banking issues of 2006.

How Dangerous Is the U.S. Current Account Deficit?

By Cletus C. Coughlin, Michael R. Pakko and William Poole

In recent years, the U.S. external deficit has attracted considerable attention from academics, policymakers and the media. One manifestation of recent trends that has raised concerns is a growing trade deficit—the difference between U.S. exports and imports of goods and services.

More generally, it is useful to consider the broader concept of the current account, which includes earnings on investments, as well as trade in goods and services. As shown in the figure below, the U.S. current account deficit has been increasing as a percentage of gross domestic product (GDP) since the early 1990s, with the present deficit exceeding 6 percent.[1]

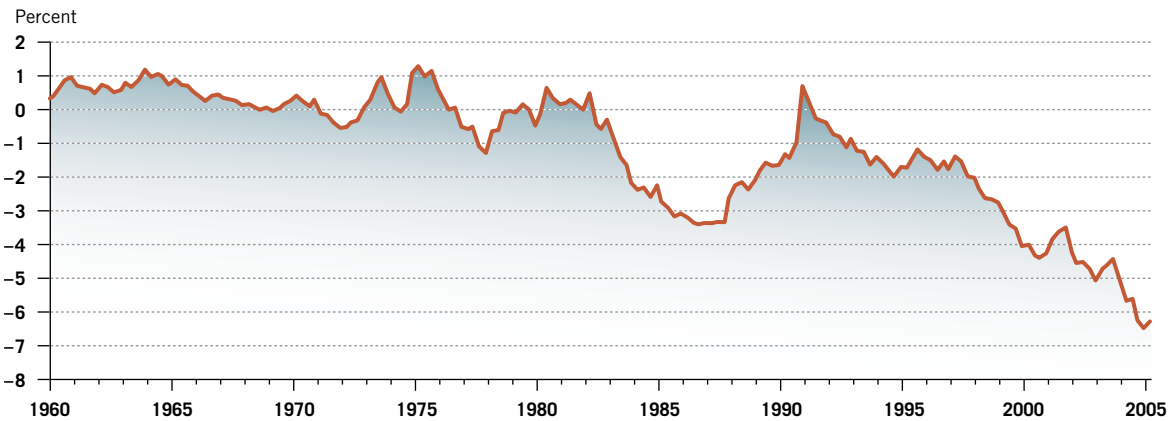
When a country runs a current account deficit, its purchases of goods and services from abroad exceed its sales of goods and services to foreign buyers. At the same time, the country is necessarily selling assets to foreigners, net of its purchases of assets abroad, in an amount equal to the current account deficit. Consequently, as current account deficits have accumulated over time, the net international investment position of the United States—the difference between U.S.-owned assets abroad and foreign-owned assets in the United States—has also grown ever larger. In light of these trends, a fundamental question is: How dangerous is the current account deficit?

As a practical matter, the U.S. net international investment position cannot become ever more negative as a percentage of GDP. In fact, economic theory suggests that it's likely that today's current account deficits will need to be trimmed or reversed over the long run. The question is not whether the U.S. current account deficit will narrow in the future but whether the inevitable adjustment is likely to be painful and disruptive of economic growth and stability—a "hard landing" precipitated by a dramatic decline in the foreign exchange value of the dollar as investors shun dollar-denominated assets.

Provided that U.S. monetary and fiscal authorities maintain sound policies, the hard-landing scenario seems unlikely. The necessary current account adjustment can be fairly slow and orderly, and it may not begin for quite some time.[2]

This outlook is based on a simple observation: For the United States, unlike almost every other country in the world, currency depreciation is inherently self-limiting. The reason for this

Balance on Current Account as a Percent of GDP *Seasonally Adjusted*



SOURCE: U.S. Bureau of Economic Analysis

result, which is discussed more fully later, hinges on the fact that U.S. assets owned by international investors are predominantly denominated in dollars, and a large fraction of U.S. assets abroad are denominated in foreign currencies.

Recent Trends in the U.S. International Investment Position

In balance-of-payments accounting, the mirror image of the current account is a measure known as the capital and financial account, which measures the international flow of capital assets. A current account deficit is exactly equal to a capital account surplus, up to unavoidable errors and omissions in the data.

It is a common mistake to treat international capital flows as though they are passively responding to what is happening in the current account. The current account deficit, some say, is "financed" by U.S. borrowing abroad. In fact, international investors buy U.S. assets not for the purpose of financing the U.S. current account deficit but because they believe these are sound investments, promising a good combination of safety and return. Moreover, many of these investments have nothing whatsoever to do with borrowing as is commonly understood, but instead involve purchases of land, businesses and common stock in the United States. A careful analysis of the nature of international capital flows is necessary before offering judgments about risks posed by the U.S. external deficit.

As trade and commerce around the world have grown increasingly integrated—the process often referred to as globalization—growth of cross-border financial flows has become particularly prominent. From 1990 through 2004, foreign ownership of U.S. assets increased at an average annual rate of nearly 12 percent, while U.S. ownership of foreign assets grew at nearly an 11 percent rate.[3] These rates are far in excess of economic growth in the United States or in the rest of the world as a whole.

Prior to 1989, the United States had a positive net international investment position. As a consequence of large capital inflows in the 1990s, however, the United States today has the world's largest negative net international investment position. By the end of 2004, foreigners owned more than $12.5 trillion of U.S. assets, based on market values, while U.S.-owned assets abroad reached a level of just under $10 trillion. The difference of $2.5 trillion amounted to more than 20 percent of U.S. GDP.

In today's world, with electronic funds transfers, financial derivatives and largely unrestricted capital flows, investors have a global marketplace in which to seek profitable returns and to diversify risk. In such an environment, aggregate patterns of international trade may be the byproduct of a process through which financial resources are seeking their most efficient allocations in a worldwide capital market. Instead of thinking that capital flows are financing the current account deficit, it may well be that the trade deficit is driven by capital flows: Capital inflows keep the dollar stronger than it otherwise would be, tending to boost imports and suppress exports, thus leading to a current account deficit.

While the conclusion that the capital account is driving the current account is surely an overstatement, it is worth emphasizing that capital flows are a highly dynamic feature of the world economy, driven by a number of economic forces. The "home bias" of investors, which has led them to invest in their home countries rather than seek optimal international diversification, has been diminishing; investors everywhere are increasingly investing outside their home countries. Countries with rapidly aging populations, especially Japan and in Western Europe, may be saving and investing in the United States against the day when their populations will be drawing down assets to support retired citizens. Capital flows to the United States have also been encouraged by the faster pace of U.S. growth relative to that of most high-income countries.

Capital inflows may also reflect the low saving rate in the United States. However, the U.S. saving rate should not be viewed in isolation: Ben Bernanke, the new chairman of the Federal Reserve, has persuasively argued that an unusually high level of worldwide savings relative to investment opportunities has resulted in downward pressure on world interest rates.[4] Investors have brought abundant capital to the United States because the profitability and security of U.S. investment opportunities make the United States something of an oasis of prosperity and stability.

In general, we should think of capital flows as the equilibrium outcome of investors worldwide seeking to acquire portfolios that balance risk and return through

diversification. The fundamental economic determinants of capital flows, and therefore the capital flows themselves, are unlikely to change quickly and massively. When we bear this perspective in mind, prospects for a painful current account adjustment in the future seem less likely.

U.S. Role in International Capital Markets

Another factor to consider is the central role of the United States in international financial markets. U.S. financial markets are among the most highly developed in the world, offering efficiency, transparency and liquidity. The U.S. dollar serves as both a medium of exchange and a unit of account in many international transactions. These factors make dollar-denominated claims attractive assets in any international portfolio. No capital market in the world has a combination of strengths superior to that of the United States. Our advantages include the promise of a good return, safety, secure political institutions, liquidity and an enormous depth of financial expertise.

For some purposes, it is useful to think of U.S. financial markets as serving as a world financial intermediary. Just as a bank channels the savings of many individuals toward productive investments, U.S. financial markets play a similar role for many investors from around the world. In the process, individuals, companies and governments accumulate dollar-denominated assets to serve as a vehicle for facilitating transactions and storing liquid wealth safely.

A bank earns its return on capital by paying a lower interest rate to depositors than it earns on its assets. Similarly, the United States earns a higher return on its investments abroad than foreigners do on their investments in the United States. Despite the fact that the U.S. net international investment position at the end of 2004 was –$2.5 trillion, U.S. net income in 2004 on its investments abroad slightly exceeded income payments on foreign-owned assets in the United States.

How can the United States earn a higher return on its assets abroad than foreigners earn on their assets in the United States? Consider currency, which pays a zero return. Over half of the total amount of U.S. currency outstanding is circulating abroad. Another factor is that much of the foreign holding of U.S. assets is in the form of Treasury bills and other debt instruments, while U.S. residents hold a much larger share of their foreign assets in the form of equities, thus earning an equity premium.

More generally, many private and governmental investors abroad rely on the U.S. capital market as the best place to invest in extremely safe and highly liquid securities. The United States as a whole earns a return from providing these safe and liquid investments to the world. The desire of foreigners to hold U.S. Treasury securities is a testament to the confidence that the world has in the safety and soundness of our financial system.

How Dangerous Is the U.S. Current Account Deficit?

In light of these considerations, let us return to the question: How dangerous is the U.S. current account deficit? The first thing to note is that many of the economic forces driving capital flows are very long-term. Portfolio reallocations occur as home bias declines, but over years rather than quarters. Firms build operations in other countries based on plans extending many years into the future. Demographic developments unfold over decades. What may appear to be an imbalance from a short-run perspective may make perfect sense over a long-term horizon.

To the extent that adjustment of the current account will involve changes in the foreign exchange value of the dollar, it is quite likely that such changes will take place over time in orderly markets. There is no inherent reason that such changes would lead to a financial market crisis; as a stable, diversified and growing economy, the United States is not likely to suffer from a sudden lack of confidence by investors so long as it maintains sound economic policies.

It is sometimes said that the United States has become a "net debtor" nation, increasing the risk that currency depreciation might lead to financial crisis. Indeed, with a current account deficit amounting to 6 percent of GDP and a negative net international investment position over 20 percent of GDP, some have drawn comparisons with Argentina, Brazil, Mexico and other countries that at times have experienced severe balance-of-payments crises.

The word "debtor" is extremely misleading in this context, for the U.S. assets

Instead of thinking that capital flows are financing the current account deficit, it may well be that the trade deficit is driven by capital flows: Capital inflows keep the dollar stronger than it otherwise would be, tending to boost imports and suppress exports, thus leading to a current account deficit.

owned by foreigners include equities and physical capital located in the United States, in addition to bonds issued by U.S. entities. Moreover, the part of the U.S. international financial position that is debt—bonds and other fixed claims, such as bank loans—is predominantly denominated in dollars. In fact, about 95 percent of international claims on the United States are denominated in dollars. A country with most of its debt denominated in its own currency is in a very different situation from one whose debt is denominated in other currencies. The familiar crises experienced by several Asian countries in 1997-98, by Mexico on several occasions and by numerous other countries have all involved situations in which the affected countries have had large external debts denominated in foreign currencies.

In these previous crises, the foreign denomination of domestic debt had destabilizing consequences. Consider what typically happens to a country suffering a balance-of-payments crisis. As the foreign exchange value of its currency depreciates, the value of its foreign liabilities—in terms of domestic purchasing power—increases, as does the burden of servicing its international debt. Recognizing this, international investors respond by paring back their positions further, engendering even greater currency depreciation. Hence, the combination of foreign-denominated debt and a depreciating currency has proved to be a vicious circle—compounding and accelerating a crisis.

The U.S. situation is completely different. To the extent that the foreign exchange value of the dollar declines, the effect on the values of U.S. and foreign asset holdings works not as an accelerator of crisis, but as part of a self-correcting mechanism. Dollar-denominated U.S. liabilities remain unchanged in domestic value, which means that debt service in dollars and relative to the size of the U.S. economy does not change. Moreover, holdings of U.S. investors abroad, about two-thirds of which are denominated in foreign currencies, appreciate in dollar terms. The composition of the U.S. international investment account, therefore, contributes to stability rather than to instability.

The significant quantitative importance of exchange rate changes on the U.S. net international investment position can be illustrated by examining specific periods in which the dollar appreciated or depreciated. Consider the years 2002-04, during which the Fed's trade-weighted exchange rate index of major currencies depreciated by nearly 27 percent.[5] Associated with the current account deficits during this period were financial flows into the United States totaling $1.6 trillion. However, because foreign claims on U.S. assets are denominated in dollars to a far greater extent than are U.S. claims on foreign assets, the depreciation increased the dollar value of U.S. assets abroad relative to foreign assets in the United States. As shown in the table below, the total valuation impact stemming from exchange rate changes was $919 billion, which was 57 percent of the net financial flows. For this three-year period, the U.S. net international investment position decreased by $202.8 billion, but absent the exchange rate adjustment, the position would have decreased by more than $1.1 trillion.

Now consider the years 1999-2001 to illustrate the impact of an appreciating dollar. During this period, the Fed's trade-weighted exchange rate index of major currencies showed a dollar

Components of Changes in the Net International Investment Position with Direct Investment at Market Value, 1999-2004 *Millions of Dollars*

YEAR	POSITION BEGINNING	CHANGES IN POSITION					POSITION ENDING
		Attributable to				Total (a+b+c+d)	
		Financial flows (a)	Valuation adjustments				
			Price changes (b)	Exchange-rate changes (c)	Other changes (d)		
1999	–1,070,769	–236,148	329,672	–125,970	65,778	33,332	–1,037,437
2000	–1,037,437	–486,373	133,716	–270,594	79,681	–543,570	–1,581,007
2001	–1,581,007	–400,243	–224,184	–151,685	17,671	–758,441	–2,339,448
2002	–2,339,448	–500,316	–59,582	231,247	212,985	–115,666	–2,455,114
2003	–2,455,114	–560,646	–1,716	415,507	229,599	82,744	–2,372,370
2004	–2,372,370	–584,597	146,514	272,278	–4,070	–169,875	–2,542,245

SOURCE: U.S. Bureau of Economic Analysis

appreciation of nearly 15 percent. Net financial flows into the United States totaled $1.1 trillion. Meanwhile, the total valuation impact of the appreciating dollar was a *negative* $548.2 billion, which is nearly half the size of the net financial flows. For this three-year period, the U.S. net international investment position decreased by $1.3 trillion. Absent the exchange rate adjustment, the decrease would have been $684.4 billion. However, the negative international investment position did not threaten to cause dollar depreciation; instead, causation went the other way, as dollar appreciation caused a significant increase in the negative net investment position.

The effects of changes in the foreign exchange value of the dollar on the U.S. net international investment position serve to stabilize the international sector of the U.S. economy. Clearly, valuation changes play a significant role in the net change in financial position that is measured in the capital account.

Other industrialized economies have incurred much larger external obligations as a percent of GDP without precipitating crises. For example, Australia's negative net investment position reached 60 percent of GDP in the mid-1990s, Ireland's exceeded 70 percent in the 1980s and New Zealand's hit nearly 90 percent of GDP in the late 1990s. Notably, these economies have recently been among the most successful—in terms of economic growth—in the industrialized world. The combination of rising external obligations and prospects for robust growth is entirely consistent: Capital flows toward countries that can make productive use of it.

A recent study by economists at the Federal Reserve Board of Governors buttresses this view.[6] The authors of the study systematically examined examples of developed industrial nations that have experienced current account reversals. The authors found that such reversals have typically been benign: Among those countries that experienced the largest declines in growth during the adjustment period, cyclical considerations appeared to be an important factor. Moreover, these cases were generally not associated with significant exchange rate depreciations. Among those cases where countries weathered the adjustment while experiencing *increasing* economic growth, exchange rate adjustments were an important factor in reducing current account deficits—primarily by raising export growth rather than lowering imports. In these cases, the exchange rate depreciation evidently played a role in buffering those economies against adverse growth consequences.

These findings provide little evidence to support a hard-landing scenario characterized by disorderly foreign exchange markets. To be sure, no country can permanently incur rising levels of net external obligations relative to GDP. If sustained indefinitely, service payments on ever-increasing obligations would ultimately exceed national income. Long before that situation of literal insolvency occurred, however, market forces would drive changes in exchange rates, interest rate differentials and relative growth rates in such a way to move the economy toward a sustainable path. Nevertheless, such adjustments need not be sudden, large or disruptive.

The international capital markets view suggests that the United States is more like those countries that have experienced high levels of debt *without* obvious ill effects than those that have suffered crises. Moreover, the U.S. case is unique in a number of respects. The central role of U.S. financial markets—and of the dollar—in the world economy suggests that capital account surpluses and, therefore, current account deficits are being driven primarily by foreign demand for U.S. assets rather than by any structural imbalance in the U.S. economy itself.

Concluding Comments

The international financial markets' view highlights the dynamic role of international capital adjustments as investors exploit the opportunities of globalized financial markets. Because the technological progress and capital-market liberalizations that have driven this process have evolved over time, the process has been protracted. Ultimately, however, when portfolio adjustments have optimally exploited new diversification opportunities, and as growth abroad rises, the net international investment position of the United States will stabilize. So also, over time, will the current account deficit decline to sustainable levels.

If this view is correct, the forces driving the U.S. capital account represent a persistent, but ultimately temporary, process that might result in a higher negative level of net claims without necessarily posing any threat to the long-run sustainability of the U.S. current account. Nor will the transition to a sustainable long-run path necessarily require wrenching adjustments in domestic or international markets or in exchange rates.

This article is based on a speech by William Poole at Lindenwood University in St. Charles, Mo., on Nov. 9, 2005. Poole is president and CEO of the Federal Reserve Bank of St. Louis. Cletus C. Coughlin is a vice president and deputy director of the Research Division at the Bank, and Michael Pakko is a senior economist there.

ENDNOTES

1. In a growing economy, a current account deficit that is increasing at the same rate as the overall economy implies an unchanging burden of indebtedness. It can, therefore, be misleading to cite current account deficits in dollar terms—it is more appropriate to express the size of the deficit in terms of a fraction of total economic output.
2. For an alternative view, see Obstfeld and Rogoff (2005).
3. Data are from the Bureau of Economic Analysis, as reported in the U.S. International Investment Position tables. Direct investment is measured at market value.
4. See Bernanke (2005).
5. A trade-weighted exchange rate index provides a measure of how the U.S. dollar has changed in value relative to a sample of other currencies (e.g., the euro, the yen, the Canadian dollar). The importance of each of the other currencies is weighted to depend on the size of the trade flows between the United States and the other countries used to compute the index.
6. See Croke, Kamin and Leduc (2005).

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Social Changes
Lead Married Women into Labor Force

By Kristie M. Engemann and Michael T. Owyang

The female labor force participation rate—the percent of civilian women who are in the labor force—has increased so much over the last 50 years in large part because many more married women are working.

Data from the Bureau of Labor Statistics and the Census Bureau show that from 1955 to its peak in 1999, the labor force participation (LFP) rate for all women increased by 24.3 percentage points. The attached figure shows that the rate for married women has more than doubled since 1955, while the rates for the other two groups have increased by much less.

Several theories try to explain this rise in married women's LFP.[1] In this article, we focus on whether social impetus—in particular, changes in intra-marital relationships—can explain the rise. We explore three hypotheses suggested by economic studies: adoption of advanced technology, changes in marital preferences and use of the birth control pill.

Household Production

Social attitudes toward women and their role in society have changed since World War II ended. However, economists Jeremy Greenwood, Ananth Seshadri and Mehmet Yorukoglu have argued that married women could not enter the labor force in large numbers until housework had become less time-consuming. Specifically, the authors focused on widespread adoption of advanced technology—e.g., washing machines, vacuums and dishwashers—that greatly reduced the time needed for housework.[2]

Greenwood, Seshadri and Yorukoglu imagined a household made up of a male who always works in the labor market and a female who always does the housework. The couple decides whether the woman also should work outside the home. The authors then determined the effects on women's LFP of technological adoption, of the decreasing gap between men's and women's wages, of the interaction of technology and wages, and of the falling price of technology (which spurs widespread adoption). They found that more than half of the increase in women's LFP was due to labor-saving technology. Only one-fifth of the increase was directly due to the declining gender-wage gap, while the remainder was caused by the interaction of the two variables.

These results show that the technology was necessary to free women's time before a better outside option could encourage them to join the labor force.

Working Mothers, Working Wives

In their 2004 study, economists Raquel Fernández, Alessandra Fogli and Claudia Olivetti hypothesized that men with working mothers were more likely to have working wives. A son's preference to marry a woman who works may have been influenced by having a working mother. Also, a working mother could make her son more productive with household chores, thus allowing his wife more time for work outside the home.

To test their theory, the authors used two datasets. One included white men whose wives were 30-50 years old when the survey was taken. After controlling for some background characteristics, Fernández, Fogli and Olivetti found that the probability that a married woman worked full-time (at the time of the survey) was 32 percentage points higher if her husband's mother worked for at least one year when he was young.[3]

Using the other survey, which includes more background information on the wife, the economists wanted to see if a mother's decision to work also affects her daughter's decision to work. If so, the relationship between having a working wife and a working mother might simply be due to marriages among couples in which both mothers worked. This sample included white couples who were 55 years old or younger when they were interviewed in 1980. Here, the authors defined a working mother as one who worked "all the time" when the husband/wife was growing up. Surprisingly, after controlling for other variables, the wife's work decision was unaffected by her own mother's labor force status. As with the first survey, the probability that the wife worked full-time increased by 24 percentage points if her husband's mother worked "all the time."

World War II data enabled Fernández, Fogli and Olivetti to determine how mothers' increasing LFP can affect subsequent generations. Different troop mobilization rates across states meant that some states saw larger increases in married women's LFP than others, where female LFP increased more in states with higher mobilization rates. The increases affected some groups of women temporarily and others permanently. To determine when increases in LFP of married women became permanent, the authors examined married white

women who were 45-50 years old in different years: 1950, 1960, 1970 and 1980, the last of which represents those who were 7-12 years old during the war.[4] States with higher mobilization rates had higher LFP among these women only in 1950 and in 1980. The increase for the former group was directly because of the war. For the latter group, the authors estimated that 16 percent of the increase in weeks worked was due to higher mobilization rates. These are the women who grew up in the new type of family where their (and their husbands') mothers had higher rates of LFP. Therefore, they were the first group of married women for which the increase in LFP due to the war was permanent.

The Pill

A 2002 study by economists Claudia Goldin and Lawrence Katz focuses on the birth control pill as a factor in women's increased LFP because it altered the timing of marriage and pregnancy. The pill was first made available, primarily for married women, in 1960. Widespread adoption among young, unmarried women, however, varied by state.[5] Goldin and Katz argued that the pill's availability to young, unmarried, college-aged women increased women's career investment and, hence, long-term LFP. Without the pill, young women who wanted professional careers would have to practice abstinence or face uncertainty regarding pregnancy. The pill, in contrast, meant that women did not have to choose one or the other, which lowered the cost of delaying marriage and investing in a long-term career.

The effect of the pill's availability on the workforce decisions of young, single women is reflected in the different marital decisions across groups. Compared with those born in 1940-49, the proportion of female college graduates born in 1950-54 who were married by age 23 declined by 8.7 percentage points, according to Goldin and Katz. Access to the pill by age 17 had a strong impact, lowering the fraction married by 3.2 percentage points, or 37 percent of the total decline.[6]

As for long-term career investments, Goldin and Katz estimated an increase of five percentage points in the share of 30- to 49-year-old women in professional occupations between 1970 and 1990.[7] Approximately 1.7 percentage points—about one-third of the total increase—can be attributed to increased pill use. The pill explains even more of the increase in the share of college women who were doctors and lawyers. Of the total increase of 1.7 percentage points, growth in pill use explains 1.2 percentage points, or nearly three-fourths of the total.

Discussion

A unifying theme in these articles is the reason for the change in female LFP. Each economic theory on increased LFP among married women comes from the idea that a working wife has become more attractive to married couples. In particular, each explanation centers on women having more marital bargaining power through spending less time on household chores, a changing social atmosphere or fertility delay. However, we considered only a few explanations and cannot conclusively identify the portion of the rise in female LFP attributable to each of these and other causes. Still, evidence from these studies reveals that, at times, innovations in economic behavior can result from social change.

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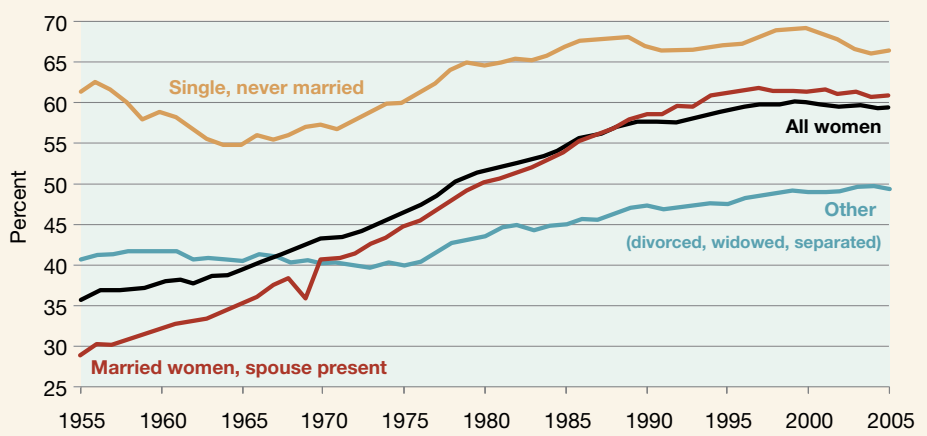
Labor Force Participation Rate



NOTE: Data from 1955 to 1975 come from the U.S. Census Bureau, *Statistical Abstract of the United States, 2003.* Data from 1976 to 2005 come from the Bureau of Labor Statistics.

ENDNOTES

1. Goldin (1990, pp. 174-76) reported that the overt discrimination of not employing married women disappeared after 1950. She attributed this to the decrease in the availability of young, single female employees, stemming from the decline in the birth rate in the 1920s and 1930s, among other things.
2. The authors reported that in 1900, the average amount of time spent on housework was 58 hours per week but only 18 hours per week in 1975.
3. The authors used the following variables: the wife's age, education and work status; the husband's age, education and income; his total number of children and total under age 6; his parents' education; whether his mother worked for at least one year after he was born but before he turned 14; and the following when he was 16 years old: his religion, his family income, his place of residence (e.g., large city, farm, etc.) and his geographic region.
4. The basis for comparison was married white women who were 45-50 years old in 1940.
5. Unmarried women below the age of majority (21 years old in all but nine states in 1969) needed parental consent before obtaining the pill until later in the decade. By 1974, however, all but two states had an age of majority of 18 years old or at least had laws where minors did not require parental consent for the pill or other family planning services. As a result, beginning with the cohort of college graduate women born in 1952 and childless before age 23, about 35 percent had used the pill before age 21.
6. In their analysis, the authors controlled for access to legalized abortion, state and year of birth, and state-of-birth time trends since states adopted more feminist views, etc., at different times.
7. Teachers and nurses were excluded from the estimation.

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Movin' On Up

By William T. Gavin

At 69 percent, the United States has a relatively high rate of home ownership; only a few countries—Ireland , Spain and Italy—have much higher rates—around 80 percent.[1] Still, one of the stated goals of current and past administrations since the Great Depression has been to increase home ownership. After remaining relatively stable around 64 percent, the rate of home ownership has risen to 69 percent in the past decade. This uptrend has been driven by a sharp rise in the rate of home ownership among young, minority and low-income households.

Old vs. Young

Home-ownership rates vary by demographic groups. The table displays information about home-ownership rates by age. The top row shows that the average U.S. home-ownership rate was 63.9 percent in 1985 and rose by only 1.2 percentage points over the following decade. This relatively flat trend, however, masked considerable divergence among age groups. For the younger age groups in the period 1985 to 1995, home-ownership rates fell. There was no change in the rate of people 55-64. Only for the oldest group, 65 and older, did home ownership rise.

Since 1995, home ownership among the oldest group rose by approximately 3.3 percentage points—a percentage point slower than in the previous 10 years. The home-ownership rates for all the younger groups, however, stopped falling and began to rise. The turnaround was greatest for the two youngest groups, which are dominated by first-time buyers.

Why was there such a large turnaround in the youngest groups? To look for an answer, we considered three factors that, to a casual observer, may have played a role in rising home ownership: the tax code, affordable-housing programs and innovations in mortgage lending that have lowered down payments.

Tax Law

One potential reason for the rise in home ownership may be the tax deduction for mortgage interest. Taxpayers who itemize are able to deduct interest payments on home mortgage loans from their taxable income. The rise of home equity loans allows homeowners to substitute mortgage debt for other types of debt, increasing the value of the deduction.

A recent study by economists Edward Glaeser and Jesse Shapiro, however, suggests that this deduction does not increase home ownership. Rather, they find that the deductibility of the mortgage interest and property tax payments encourages those who are already homeowners to buy larger and more expensive homes.

Taxpayers are also allowed to deduct payments of state and local taxes paid on real property. In addition, since 1997, homeowners have been allowed to take a tax-free capital gain up to $250,000 on the sale of a principal residence every other year. These tax features also encourage homeowners to demand larger and more expensive homes, but this demand would have the effect of raising home prices, thus hurting, not helping, first-time homebuyers.

Affordable-Housing Programs

Another possible explanation for the rise in home ownership among the young may be government affordable-housing programs. The Department of Housing and Urban Development (HUD) has three such programs: HOZ, SHOP and HOME.

The Homeownership Zone (HOZ) program helps communities reclaim vacant and blighted properties, increase home ownership and promote economic revitalization by creating entire neighborhoods of new, single-family homes. Authorizations under this program subsidized about 2,000 new homes in 1996 and another 1,400 in 1997. The program has not been funded since then.

The Self-Help Homeownership Opportunity Program (SHOP) provides funds for nonprofit organizations to buy homesites and develop or improve the infrastructure needed to set the stage for sweat equity and volunteer-based home-ownership programs for low-income families. An example is Habitat for Humanity. Funding for SHOP was about $25 million in fiscal year 2005, a bit less than fiscal 2004 but about the same as fiscal 2003.

The Home Investment Partnerships Program (HOME) was created under Title II of the National Affordable Housing Act of 1990. HOME has

become a key funding source supporting HUD's home-ownership goals. In December 2003, President Bush signed into law a new initiative under HOME—the American Dream Downpayment Initiative Act (ADDI). The act authorizes up to $200 million in grants to help first-time homebuyers with the biggest hurdle to home ownership: down payment, closing costs and rehabilitation costs.[2] Bush's administration expects ADDI to fund approximately 40,000 households annually. At this rate, it would take approximately 25 years to increase the home-ownership rate just one percentage point. Note that, on average, about 500,000 renters became homeowners during each year between 1995 and 2005.

Financial Innovations

While changes in the tax law and affordable-housing programs do not seem to account for the dramatic rise in first-time buyers over the past decade, recent evidence suggests that financial innovations do. Economists Matthew Chambers, Carlos Garriga and Don Schlagenhauf have found that a lower down-payment requirement explains the rise in home ownership, especially for young and first-time buyers.

There have been two innovations in mortgage contracts that have allowed for lower down payments. The first is the development of private mortgage insurance (PMI). When the down payment is less than 20 percent of the purchase price, homebuyers using private mortgage companies must buy mortgage insurance. Recently, premiums for PMI have ranged between 0.19 and 0.96 percent of the mortgage loan, depending on the maturity of the loan and the amount of the down payment.[3]

A second innovation, the combo loans—"80-20" and "80-15-5" loans—are quite often less expensive than mortgage insurance. With both types, the buyer takes out two loans. The first loan corresponds to the traditional loan-to-value rate of 80 percent, while the second loan is for the 20 percent down payment. The second loan has a higher interest rate—approximately 2 percentage points higher than the primary mortgage's rate. This mortgage program is frequently cheaper than a program with PMI because the 2 percentage point premium applies only to the second smaller loan. Under the "80-15-5" program, a buyer makes a down payment of 5 percent and takes out a second mortgage for the remaining 15 percent.

A number of private programs also reduce closing costs. These include the Nehemiah Program, the AmeriDream Downpayment Assistance Program, HART Action Resource Trust, Consumer Debt Solutions Inc. and Partners in Charity. The Nehemiah Program, for instance, donates the down payment and closing costs for qualified homebuyers. The donation ranges from 1 percent to 6 percent of the final contract price, depending on the particular needs of the homebuyer. The size of the gift and the home price are limited because the homebuyer's monthly payment for principal, interest, taxes and insurance cannot exceed 29 percent of income. Any home on the market can be a Nehemiah participating home as long as the seller agrees to contribute 3 percent of the sales price of the house to the Nehemiah Corp. and pay a processing fee of $499. The benefits to the seller include access to a wider market of homebuyers and less need to negotiate the selling price. The contribution by the seller to Nehemiah may also be tax deductible as a cost of sale.

Home, Sweet Home

Recent advances in the home-ownership rate have been characterized by a relatively large number of first-time buyers. It is interesting to note that the last large increase in the home ownership rate (from 44 to 64 percent) occurred after WW II. Then, the Veterans Administration guaranteed the payments of principal and interest so that returning war veterans did not have to make a down payment.[4] After 30 years of being stuck near 64 percent, the home-ownership rate has begun to rise again. The explanation is lower down payments, which have allowed more young people to buy homes.

William T. Gavin is a vice president and economist at the Federal Reserve Bank of St. Louis.

Home-Ownership Rates by Age

Age Group	% rate in 1985	Percentage-point change in rate of home ownership: 1985 to 1995	Percentage-point change in rate of home ownership: 1995 to 2004	% rate in 2004
U.S. total	63.9	1.2	5.9	68.6
Younger than 35 years	39.9	– 3.3	9.2	42.3
35 to 44 years	68.1	– 4.4	5.4	68.8
45 to 54 years	75.9	– 0.9	2.4	77.0
55 to 64 years	79.5	0.0	2.7	81.7
65 years and over	74.8	4.3	3.3	80.7

SOURCE: Housing Vacancy Survey, Table 15, U.S. Census Bureau, 2005

ENDNOTES

1 See *The Economist*, "Going Through the Roof," March 30-April 5, 2002, p. 65, for a cross-country comparison of home-ownership rates.

2 In 2003, the ADDI appropriation was $74.5 million. In 2004, HUD announced $161.5 million in funding for the ADDI.

3 See the web site of Professor Jack M. Guttentag, University of Pennsylvania, www.mtgprofessor.com.

4 See Colton (2003).

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River Keeps Jeffersonville's Economy Rolling

By Glen Sparks

In the past few years, Jeffersonville has begun to develop its riverfront space. Buckhead Mountain Grill is a popular restaurant that offers great views of downtown Louisville.

Jeffersonville, Ind.

BY THE NUMBERS

Population ..... Jeffersonville 28,640 (2004)
Clark County 100,706 (2004)

County Labor Force ..... 53,854 (Nov. 2005)

County Unemployment Rate ..... 5.2 percent (Nov. 2005)

County Per Capita Income $28,186 (2003)

Top Employers

U.S. Census Bureau 2,000
Clark County Hospital 1,600
Clark County Schools 1,600
American Commercial Lines 1,100
Monarch Beverage 592

For a mile and a quarter on the northern bank of the Ohio River, in Jeffersonville, Ind., barge building gets top priority.

Machinists, carpenters, pipe fitters and other trades people will complete about 350 barges this year for Jeffboat, a subsidiary of Jeffersonville-based American Commercial Lines. Jeffboat, just across the river from Louisville, Ky., also builds towboats and manages a dockside repair facility. The company calls itself the largest inland boat-building company in the United States.

ACL operates 3,200 barges and 124 towboats that transport more than 45 million tons of freight annually, mostly on the inland waterways of North America. ACL International transports bauxite (an ore used to make aluminum) along 355 miles of the Orinoco River in Venezuela.

Chris Black, ACL's chief financial officer, says, "Our business and our industry are probably better positioned today than they have ever been. And our balance sheet is certainly the strongest it has ever been."

Like many industries, barge building is cyclical. Right now, the cycle is up. In November 2005, Jeffboat added 100 hourly jobs, most of which pay between $18-20 an hour.

Jerry Linzey, senior vice president for manufacturing at ACL, says revenue at Jeffboat should reach $220 million this year and zoom up to about $300 million next year. Total revenue at ACL last year was $600 million.

Barge building is booming for several reasons. For one, it's relatively cheap to ship products by barge—an important consideration in this age of rising energy prices. One gallon of fuel will transport one ton of barge cargo for 500 miles. That compares with 200 miles by rail and 60 miles by truck.

"Hauling by barge is the most fuel-efficient, safest mode of transportation," says Norb Whitlock, senior vice president and chief operating officer of ACL.

Builders also are benefiting because many barges built during a boom 25 years ago now need replacing. Spot shortages are popping up, says Black.

Whitlock says, "We're going to see strong demand in the barge industry for at least the next three to five years."

The decision to go public also has helped ACL. The company filed for an initial public offering (IPO) in July 2005, at a price of $21 a share. In October, ACL announced that it had sold almost 9.5 million shares of common stock.

"Bottom line, we've been able to go from about $400 million in debt to about $200 million in debt, and $150 million of that was from the IPO," Black says. "The company has emerged much stronger than before."

Beyond Barges

Growth at ACL should at least partly offset the closing of the Colgate-Palmolive plant in neighboring Clarksville. Colgate-Palmolive executives announced in October that the toothpaste-making plant will stop production by January 2008. About 500 employees will lose their jobs.

One of the local mainstays is the U.S. Census Bureau office. Information collected from across the country on topics such as leading economic indicators, retail sales and housing starts is compiled in

Jeffboat expects to build 350 barges this year. Jeffersonville has been a center for ship-building since 1834.

Jeffersonville. During most years, about 2,000 people work at the bureau. In the second and seventh years of each decade, in preparation for the economic census, the office hires an additional 1,500 workers. The bureau hires 4,000 extra workers every 10 years, also on a temporary basis, to compile the population census. Most workers hail from the Jeffersonville area.

"A lot of times, it's housewives or other people who just want to make a little extra money," says Linda Hayden, an operations specialist at the census office in Jeffersonville.

Just to the north of Jeffersonville is a 6,300-acre Indiana Army ammunition complex that is being converted into the River Ridge Industrial Park. Congress conveyed the land to the River Ridge Development Authority in 1998. The authority wants to attract auto parts plants, fabricated steel manufacturers, food processing firms and companies that need large warehouse space.

Capstone Realty Co. recently paid $2 million for 67 acres on the southern portion of the property. It wants to build 1.2 million square feet of industrial warehouse space.

The authority has set a goal to sell and develop at least 30-50 acres a year for the next decade. In the second decade, the authority hopes to develop about 75 acres a year.

"There are so many old Army grounds in the country, but most of them are in rural areas," says Marc Elliott, head of the River Ridge Redevelopment Authority. "The advantage here is that we have a huge piece of property in a metropolitan area that is ripe for development."

A Town with a View

Jeffersonville also is jazzing up its riverfront area, offering tax abatement as an incentive. New restaurants like Rocky's By the River and the Buckhead Mountain Grill sit on the banks of the Ohio. Large windows offer diners a great view of the river and downtown Louisville.

"For a long time, if you had anything ugly, you put it down by the riverfront," says Paul Coomes, who is an economist at the University of Louisville. "Now, that's changing."

In historic downtown Jeffersonville, business owners sponsor a farmer's market, outdoor movie showings and concerts in Warder Park. Jeffersonville Main Street, a nonprofit development group, funds the Front Porch Project, which helps businesses secure grants for exterior improvements.

"Our biggest goal is to get people to come downtown and to shop at the mom-and-pop shops," says Jay Ellis, executive director of Jeffersonville Main Street. "Is it working? Well, I've been here 10 years, and I know downtown used to be a lot quieter than it is now."

Despite the improvements, Jeffersonville may suffer from a bit of an identity crisis. Besides being overshadowed by Louisville, it sits side by side with two other cities in this bend of the river—Clarksville to the north and New Albany to the west.

"You really can't tell the difference from one town to another," says Norman Pfau, the president and CEO of George Pfau's Sons Co. Inc., in Jeffersonville, a company that turns animal fats into industrial lubricants. "I kind of think of them as one city."

Bill White, the president and chief executive officer of 1st Independence Bank in Jeffersonville, says the three towns complement one another. In general, despite some bad news like the Colgate-Palmolive announcement, White calls the southern Indiana economy "vibrant."

Clarksville has several big-box developments, White says. New Albany has built strip malls. Jeffersonville, he says, "seems to be a little more progressive. Jeffersonville has this interesting mix of older industries like Jeffboat, but it also is making progress along the riverfront and downtown area. At one time, it was more of a blue-collar, factory town, I think. You can't say that now."

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

Cranes load and unload goods at the Port of Indiana-Jeffersonville, also known as Clark Maritime Center, along the Ohio River. Clark is the fastest growing port on the Inland Waterway System.

Steel Businesses Make Port Strong

From one small grain business that rented space on one little dock in the late 1980s, the Port of Indiana-Jeffersonville has become a local economic giant.

In 2005, the port—also known as the Clark Maritime Center—handled about 1.6 million tons of cargo, worth about $452 million, says Jody Peacock, a spokesman for the Ports of Indiana, which operates the center and two other ports in the state. The 1,000-acre facility in Jeffersonville has about 30 tenants and 1,500 employees.

The port opened in 1988. Since the early '90s, it has really taken off, says Brian Sieg, manager of port operations. It's the fastest-growing port on the Inland Waterway System.

Why So Busy?

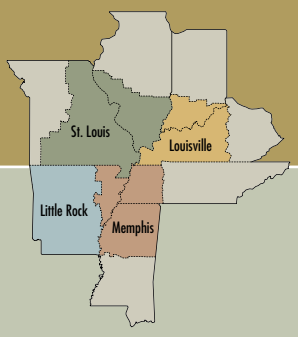
For one, Jeffersonville is adjacent to the nation's "automotive and appliance alley." Toyota, Ford and General Motors operate assembly plants in the region, as do General Electric and Whirlpool.

Also, some port tenants complete the first phase of manufacturing before sending products to their distributors. Nova Tube, for instance, rolls steel into cylinders that eventually become the chassis for Ford F-150 trucks.

The port has 13 steel-related firms, meaning tenants can offer a variety of complementary services. Voss/Clark Industries pickles steel (to remove rust) for other port tenants. Steel Dynamics Inc. galvanizes steel coils.

Peacock says a major goal of the Ports of Indiana staff is to attract companies that can benefit from one another. The port organization maintains all the roads and other infrastructure on the property. The facility still has a few hundred acres of developable land.

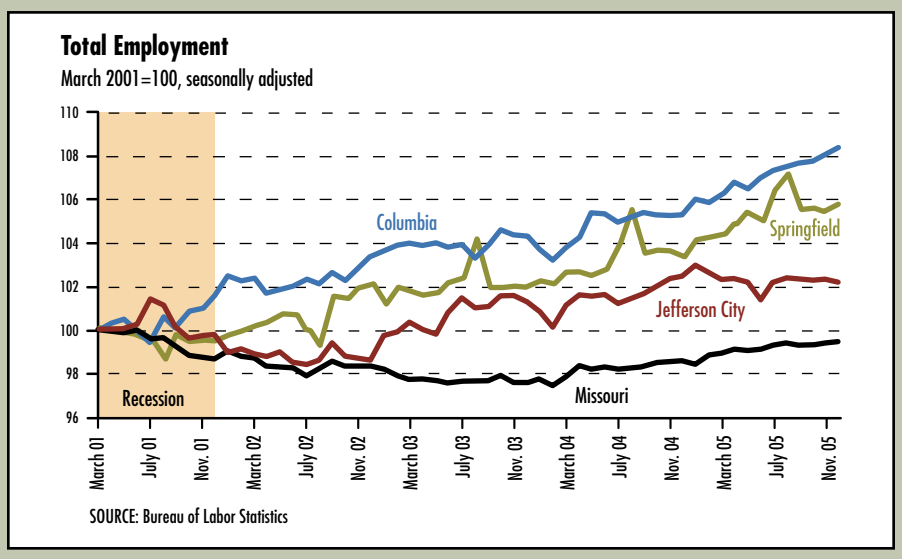
"The port is kind of like a giant, maritime mall," Peacock says. "If you get all the stores together, then they can be much stronger than if you have just one or two stores."



Three Metro Areas Outside St. Louis Outpace State of Missouri as a Whole

By Elizabeth A. La Jeunesse and Christopher H. Wheeler

Jefferson City, Springfield and Columbia—the three metropolitan areas located in the St. Louis Zone of the Eighth Federal Reserve District, other than St. Louis—all saw their labor markets expand over the past five years in excess of what the state of Missouri as a whole experienced. All three metropolitan areas saw their employment decrease modestly during the national recession, which lasted from March 2001 to November 2001, then subsequently rise beyond pre-recession levels. As shown by the figure, employment as of December 2005 in Jefferson City, Springfield and Columbia stood, respectively, 2.2, 5.9 and 8.4 percent above their March 2001 levels, whereas the entire state remained 0.6 percent below its pre-recession level.



Jefferson City began experiencing steady employment gains toward the end of 2002, picking up roughly 2,600 jobs between January 2002 and December 2004. In 2005, however, the labor market cooled off somewhat, as total nonfarm employment fell by 0.7 percent or approximately 600 jobs. These recent losses were shared across both goods producers and service providers, although the former accounted for about two-thirds of the losses. In the case of the latter group, there were notable job gains last year within the broad sector of trade, transportation and utilities. However, these gains were more than offset by losses among other service providers, as well as in government employment.

Springfield demonstrated even stronger growth than Jefferson City over the past four years. Between January 2002 and December 2004, Springfield's employers added more than 6,000 jobs, a 3.6 percent gain. This upward trend continued last year, as payrolls rose by an additional 3,100 jobs. All of these job increases were due to Springfield's growing service industry. Employers in goods producing sectors continued to shed workers over the last year, losing roughly 600 employees in 2005.

Equally impressive has been the labor market performance of **Columbia**, which has seen its employment trend steadily upward since the end of 2001. In the three years ending in December 2004, Columbia's total employment rose by 2,400 or nearly 3 percent of its January 2002 level. Last year, the rate of job creation actually increased—total employment rose by 2.3 percent or 2,000 jobs. These gains were seen primarily in the service sector, including retail establishments, although smaller job gains were also registered by goods producers.

In spite of the impressive labor market gains in Jefferson City, Springfield and Columbia, the state of **Missouri** as a whole has continued to struggle to regain jobs lost during the recession. Even by the start of 2005, when the state's labor market had finally begun to show consistent growth, employment increased by only about 1 percent or roughly 27,000 jobs. By the end of last year, Missouri's employment remained more than 16,000 jobs below its pre-recession level. Analysts widely acknowledge job losses in manufacturing to be driving Missouri's job slump. Although goods producers recovered somewhat last year, adding nearly 9,000 jobs to their payrolls, employment in this sector remained more than 40,000 below its March 2001 level.

The industrial compositions of these three cities, which are not as heavily engaged in goods-production as the state as a whole, may explain why Jefferson City, Springfield and Columbia have outpaced Missouri in terms of employment during the past five years. For certain, the data reveal that Jefferson City, Springfield and Columbia are three bright spots amid a struggling Missouri labor market.

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.

Rock Solid in Little Rock?

By Giang Ho and Anthony Pennington-Cross

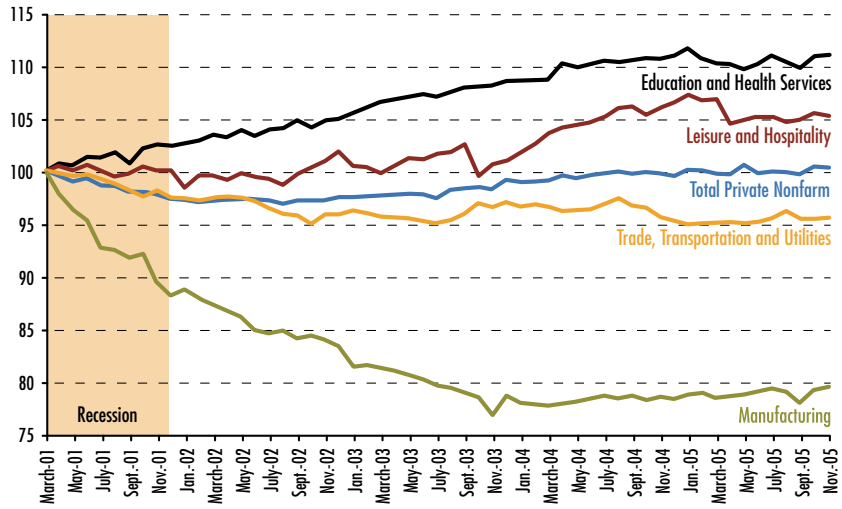
Compared with some other parts of Arkansas, employment in the Little Rock-North Little Rock metro area has been slow to recover from the 2001 national recession.[1] For example, from March 2001 through December 2005 (more than four years after the recession officially ended), private nonfarm payroll employment in the Little Rock area increased by 1.2 percent, compared with 17 percent in the Fayetteville-Springdale-Rogers metro area, in northwestern Arkansas. After returning to pre-recession levels in June 2004, there has been virtually no change in Little Rock's employment. Yet there are reasons to be optimistic about Arkansas' capital: above-average income growth and modest population growth.

Reflecting its role as a regional center serving a large and mostly rural hinterland, Little Rock has a diverse industry mix that emphasizes health care, construction and transportation. An important economic engine for Little Rock is the education and health services sector, which accounts for 16 percent of the regional economy. As shown in the figure, this sector has outperformed others, growing by 11 percent since the beginning of the 2001 recession. However, job growth was offset by weaknesses in the trade, transportation and utilities (TTU) sector, which since March 2001 has declined by 5 percent, an equivalent of 1,200 jobs. Given the relative importance of TTU in the regional economy (more than a quarter of the region's labor force), it is not surprising that total employment growth has been stagnant.

Meanwhile, manufacturing in Little Rock stabilized during 2004 and 2005 after a long period of steady job losses (more than 20 percent since March 2001). The impact of declining manufacturing on the Little Rock economy is mitigated since the sector accounts for only 10 percent of employment, compared with 17 percent for Arkansas as a whole. The down side, however, is the loss of high-technology employment in industries such as aerospace manufacturing; this loss may have detrimental impacts on the region's future.

Employment in the Little Rock-North Little Rock Metropolitan Area

March 2001=100, seasonally adjusted



SOURCE: Bureau of Labor Statistics

Other sectors such as construction and leisure and hospitality have enjoyed steady, though not stellar, growth in recent years.[2] From March 2001 through December 2005, the natural resources, mining and construction sector grew by 1.2 percent and the leisure and hospitality sector by 4.8 percent. Despite some signs that the housing market is cooling in other parts of the United States, residential construction showed no sign of slowing during 2005 in Little Rock. This may be partly due to the emerging wave of housing in downtown in response to local revitalization efforts. In addition, the November 2004 opening of the Clinton Presidential Library in downtown Little Rock should not be discounted as a positive economic force; it is likely associated with increased nonresidential construction, as well as job creation in the leisure and hospitality sectors as tourists drive and fly to Little Rock.

Although Little Rock's overall job growth has lagged behind that in other parts of Arkansas in the past few years, its unemployment rate of 4.5 percent (12-month average for 2005) is below the average for the state (5 percent) and the country (5 percent). In addition, per capita income has been growing faster than the national average. For example, during 2000-2003, nominal per capita income for Little Rock increased by 11 percent compared with 5.5 percent nationally. After adjusting for inflation, Little Rock per capita income increased by 3.9 percent while U.S. per capita income actually declined.[3] This may suggest that local productivity growth is running at a faster pace in Little Rock than for the nation as a whole.

Further, Little Rock has experienced slow population growth compared with booming northwestern Arkansas. For example, the population in Pulaski County, where the city of Little Rock lies, increased by 1.2 percent between 2000 and 2004, while Fayetteville County, the core county of the Fayetteville-Springdale-Rogers metro area, grew by more than 10 percent.[4] However, one recent Brookings Institution study ranked Little Rock the No. 12 "Wealth Builder" among the 100 largest metropolitan areas.[5] (A "Wealth Builder" is defined as a region that can raise incomes without fast population growth.)

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

ENDNOTES

1 The Little Rock-North Little Rock metropolitan area, referred to as simply Little Rock elsewhere in this article, includes Faulkner, Grant, Lonoke, Perry, Pulaski and Saline counties, all in the state of Arkansas.

2 The leisure and hospitality sector is made up of the arts, entertainment and recreation sector and the accommodation and food services sector.

3 "2005 Economic Review and Outlook," December 2005. See www.metroplan.org/datacenter/Econ2005.pdf.

4 "2005 Demographic Review and Outlook," June 2005. See www.metroplan.org/datacenter/2005DemR&O.pdf.

5 "Growth Without Growth: An Alternative Economic Development Goal for Metropolitan Areas," by Paul Gottlieb, February 2002. See www.brooking.edu/metro/publications/gottliebexsum.html.

Economy Overcomes Hurricanes, Rising Energy Prices

By Kevin L. Kliesen

The U.S. economy performed admirably last year. Despite three major hurricanes that helped spur sharp increases in energy prices, real GDP increased by more than 3 percent for the third consecutive year, and the unemployment rate dropped to its lowest level in more than four years.

2005 Goes Out like a Lamb

The U.S. economy stumbled late last year, as real GDP grew at only a 1.6 percent annual rate in the fourth quarter. The economy's anemic rate of growth came on the heels of a 3.8 percent gain over the first three quarters of the year. For the year (percent change, fourth quarter of 2004 to fourth quarter of 2005), real GDP increased by 3.2 percent, which was roughly 0.5 percentage points less than 2004's increase.

Last year's slower growth can probably be attributed to hurricanes and rising energy prices. One rule of thumb is that each $10 per barrel increase in crude oil prices reduces the level of real GDP by 0.4 percent after four quarters. Accordingly, the roughly $13 increase in the refiners' cost of crude oil over the four quarters of 2005 may have trimmed real GDP by as much as 0.5 percentage points. The reduced level of economic activity and damages wrought from hurricanes Katrina, Rita and Wilma also contributed to the slowdown, though how much is difficult to determine at this time. Despite these hurdles, faster growth over the first three quarters of the year (relative to trend growth) caused the unemployment rate to fall to 4.9 percent in December 2005, half a percentage point lower than a year earlier.

Although energy prices paid by consumers rose for the fourth consecutive year, inflation edged lower last year. Following a 3 percent increase in 2004, the price index for personal consumption expenditures (PCE) rose by 3 percent in 2005. Excluding food and energy prices—the core PCE—inflation declined from 2.25 percent in 2004 to 1.9 percent last year. The modest slowing in core inflation suggests that businesses found it difficult to pass along higher energy costs to the consumer.

2006 Comes In like a Lion

Many economists viewed the fourth-quarter slowdown as an aberration. Thus far, that appears to be an accurate assessment. In January, real consumer spending and new factory orders and shipments for nondefense capital goods excluding aircraft were both up strongly from three months earlier. Similarly, manufacturing production and nonmanufacturing business activity remained at a high level over the first two months of the year, according to the Institute for Supply Management surveys.

Accompanying the faster growth in sales and production has been a solid improvement in labor market conditions. Nonfarm payroll employment rose by 170,000 in January 2006 and 243,000 in February. With lower energy prices and Gulf Coast rebuilding efforts adding to the momentum, it is possible that real GDP growth could average 4 percent over the first half of this year.

The Prospects for 2006 Look Good...So Far

The beginning of each year brings a bevy of macroeconomic forecasts freely available to the public. Among the most watched are those from the Congressional Budget Office, the Council of Economic Advisers and the Federal Open Market Committee (FOMC). This year's forecasts are pretty similar: Real GDP growth is projected to increase by about 3.5 percent, and the unemployment rate is expected to remain about 5 percent. Most forecasters predict inflation using the growth in the consumer price index (CPI), which was 3.7 percent over the four quarters of 2005. Forecasters expect that an absence of energy price increases this year will push the CPI inflation rate down to just under 2.5 percent during 2006. In the February 2006 *Monetary Policy Report to the Congress*, the FOMC, which instead focuses on the core PCE, projects that core inflation will remain at about 2 percent.

As with any year, it is possible to identify several risks to the outlook. This year's list includes the possibility of a sharp fall in housing prices, which could crimp economic growth by slowing housing construction or limiting households' use of equity wealth to finance a portion of their consumption outlays. Other factors to consider are rising geopolitical risks that keep oil prices high and a further slide in productivity growth, which would raise the unit costs of businesses and cut into profits. For now, the prevailing view is that 2006 will bring a modest acceleration in economic growth, a dip in headline inflation, but no slowing in core inflation.

Kevin L. Kliesen is an economist at the Federal Reserve Bank of St. Louis. *John M. McAdams provided research assistance.*

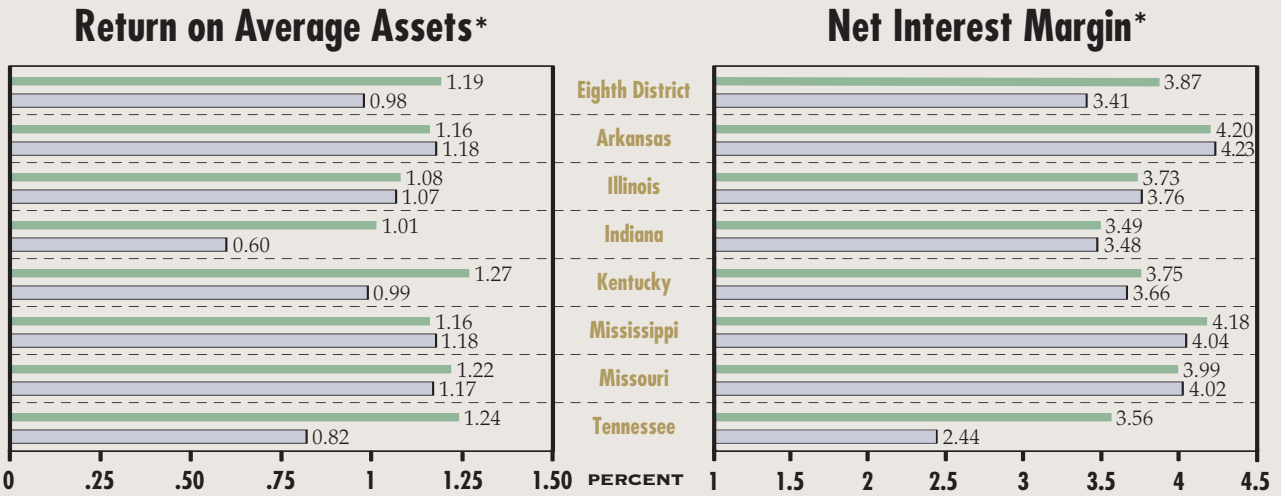
National and District Data

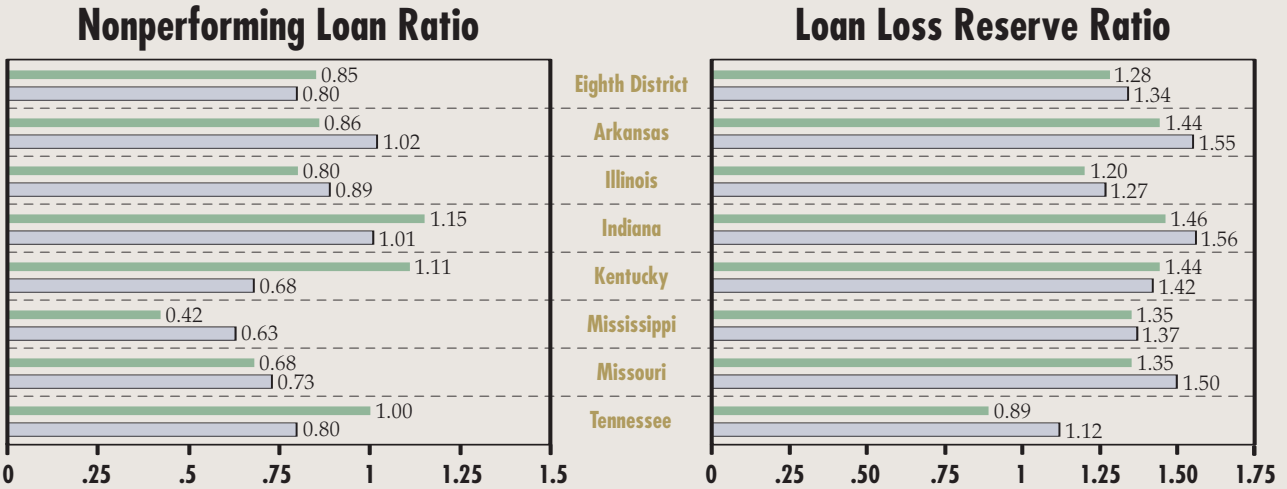
SELECTED INDICATORS OF THE NATIONAL ECONOMY AND BANKING, AGRICULTURAL AND BUSINESS CONDITIONS IN THE EIGHTH FEDERAL RESERVE DISTRICT

Commercial Bank Performance Ratios

FOURTH 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*	1.31	1.24	1.15	1.38	1.26	1.36	1.31	1.30
Net Interest Margin*	3.55	4.35	4.35	4.33	4.34	3.86	4.10	3.33
Nonperforming Loan Ratio	0.75	0.68	0.73	0.60	0.67	0.60	0.63	0.81
Loan Loss Reserve Ratio	1.28	1.27	1.30	1.28	1.29	1.26	1.28	1.28





Fourth Quarter 2005 Fourth 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/fred2/

Regional Economic Indicators

Nonfarm Employment Growth*

YEAR-OVER-YEAR PERCENT CHANGE

	FOURTH QUARTER 2005								
	UNITED STATES	EIGHTH DISTRICT	ARKANSAS	ILLINOIS	INDIANA	KENTUCKY	MISSISSIPPI	MISSOURI	TENNESSEE
Total Nonagricultural	1.4%	1.1%	1.7%	1.0%	1.0%	1.5%	–0.2%	1.0%	1.3%
Natural Resources/Mining	6.9	5.3	4.4	7.7	1.5	10.4	–5.2	6.9	3.4
Construction	4.1	2.2	6.1	0.2	1.0	2.6	10.2	2.3	3.2
Manufacturing	–0.7	–1.1	–1.7	–1.3	–0.2	–0.5	–2.5	–1.5	–1.4
Trade/Transportation/Utilities	1.2	0.9	1.4	0.2	1.0	0.9	–0.1	1.3	1.8
Information	–0.8	–1.0	–0.2	–1.3	0.1	0.8	–4.6	–2.3	0.3
Financial Activities	1.9	1.5	1.8	2.0	0.0	1.3	–0.7	2.4	0.9
Professional & Business Services	2.9	3.1	2.9	3.2	2.1	4.1	7.2	3.2	2.1
Education & Health Services	2.1	2.2	2.8	2.3	2.2	1.8	0.9	2.2	2.5
Leisure & Hospitality	2.0	2.0	2.8	2.7	2.1	2.7	–5.4	1.5	3.7
Other Services	–0.4	0.2	2.3	0.8	0.4	0.3	–1.2	–1.8	0.6
Government	0.7	0.4	2.5	0.1	0.5	1.3	–0.3	–0.5	0.1

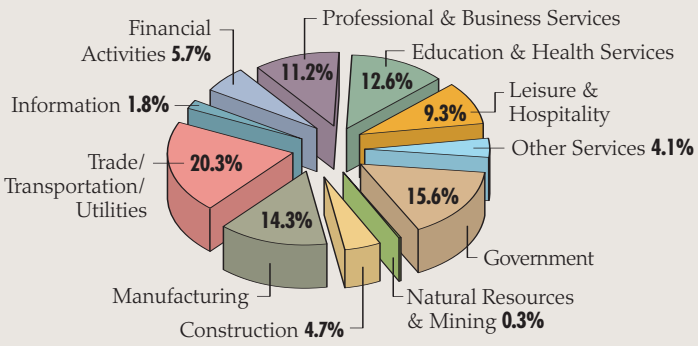
Unemployment Rates

PERCENT

	IV/2005	III/2005	IV/2004
United States	4.9%	5.0%	5.4%
Arkansas	4.8	4.9	5.3
Illinois	5.4	5.7	6.1
Indiana	5.4	5.5	5.4
Kentucky	6.4	6.3	5.3
Mississippi	9.3	8.3	7.1
Missouri	5.2	5.2	5.9
Tennessee	5.5	5.5	5.7

Eighth District Payroll*

EMPLOYMENT BY INDUSTRY-2005



FOURTH QUARTER

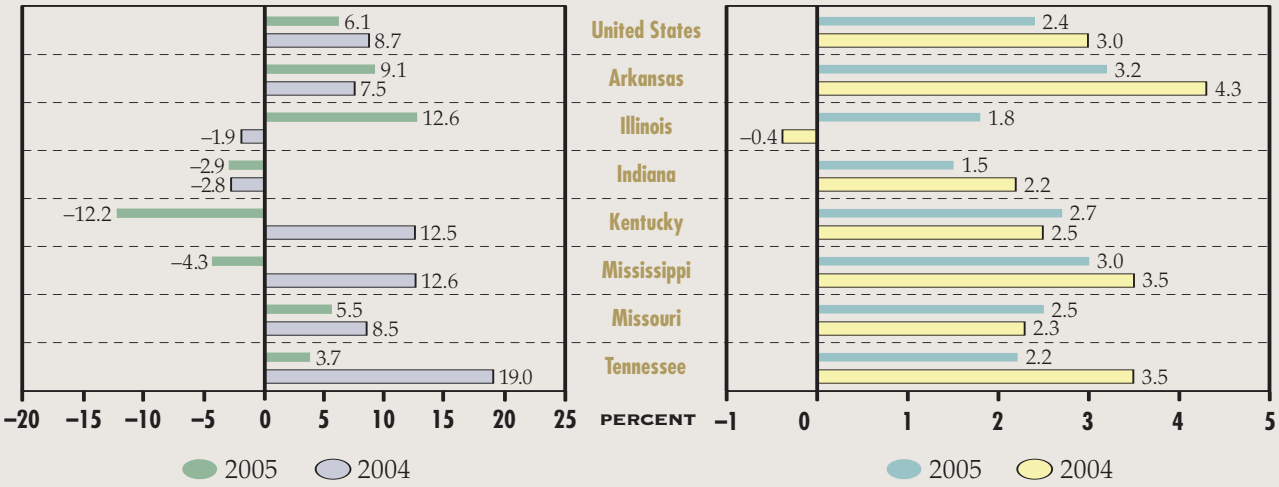
Housing Permits

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

THIRD QUARTER

Real Personal Income‡

YEAR-OVER-YEAR PERCENT CHANGE



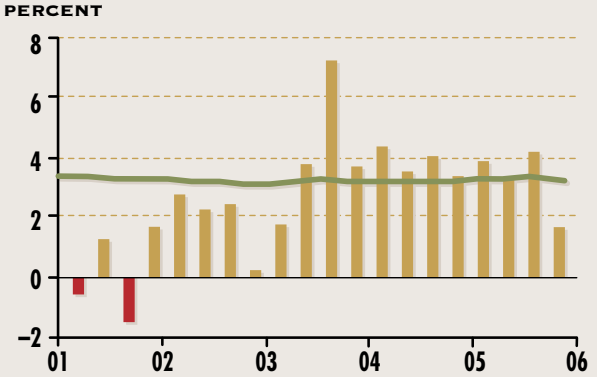
*NOTE: Data have been converted from the 1987 Standard Classification (SIC) system basis to a 2002 North American Industry Classification (NAICS) basis.

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

Major Macroeconomic Indicators

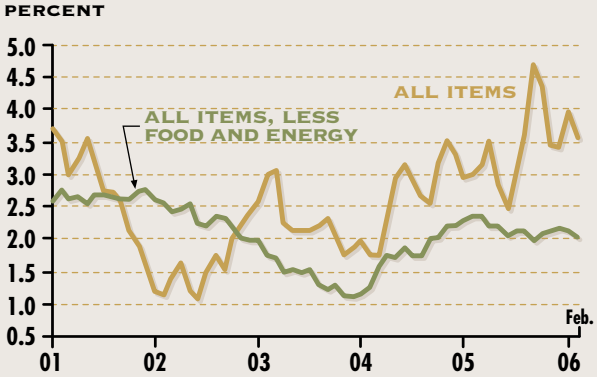
Additional charts can be found on the web version of *The Regional Economist*. Go to www.stlouisfed.org/publications/re/2006/b/pdf/4_06_data.pdf.

Real GDP Growth



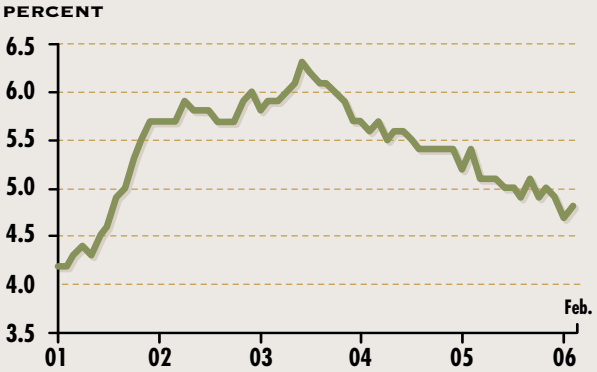
NOTE: Each bar is a one-quarter growth rate (annualized); the green line is the 10-year growth rate.

Consumer Price Inflation



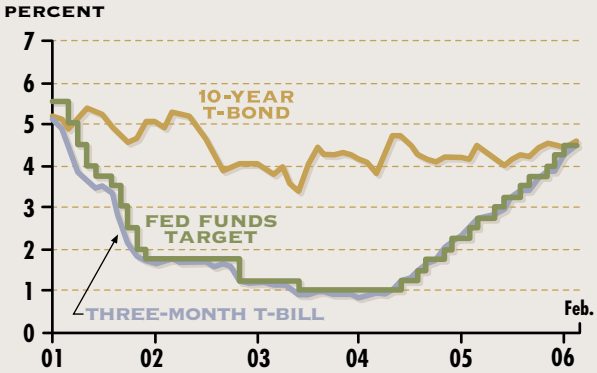
NOTE: Percent change from a year earlier

Civilian Unemployment Rate



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

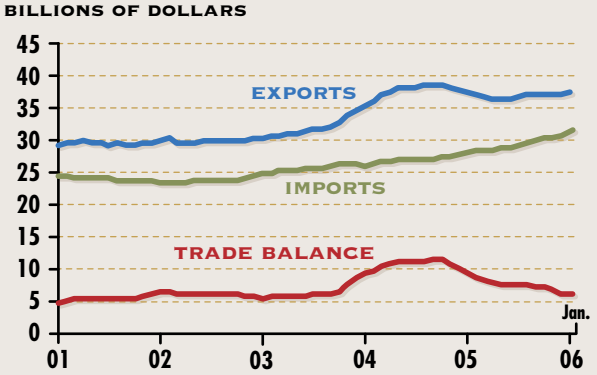
Interest Rates



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

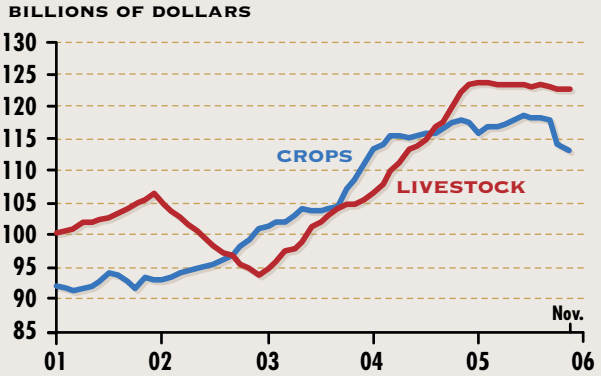
Farm Sector Indicators

U.S. Agricultural Trade



NOTE: Data are aggregated over the past 12 months.

Farming Cash Receipts



NOTE: Data are aggregated over the past 12 months.

U.S. Crop and Livestock Prices