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FEDERAL RESERVE BANK OF SAINT LOUIS

The Regional Economist

A Quarterly Review of Business and Economic Conditions

Industrial Loan Companies

Feel the Heat of the Spotlight

GASOLINE PRICES
"Gouging" by Stations Ensures Adequate Supply

MASS RETIREMENT
As Boomers Slow Down, So Might the Economy

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President's Message

William Poole

PRESIDENT AND CEO, FEDERAL RESERVE BANK OF ST. LOUIS

"If vanity plates are supposed to say something about a person, what better plates could I have?"

Driving Home the Responsibilities of a Policymaker

I've often been asked why I chose the equation "MV–PT" as my car license plate number. (Missouri doesn't provide for an "equals" sign on the license plate; so, I have a dash instead.) For those not familiar with the monetarist tradition in economics or its impact on central banking, my plates must seem a mystery. But for me, they represent a constant reminder of my duties and responsibilities as a policymaker, not to mention my profession. I'm sure that more than one economist has smiled when seeing this plate out on the road. (Others probably think it a cute reminder of a strong marriage between Maggie Violet and Peter Thomas. Nice to be part of the "in" crowd now, isn't it?)

MV=PT stems from the quantity theory of money. This theory, in turn, is reflected in the well-known description of inflation—too much money chasing too few goods. In past centuries, during which many major countries adhered to a monetary system based on gold, world gold discoveries led to large increases in national money supplies. Such increases eventually led to large price increases.

Several notable economists, including David Hume (writing in the mid-18th century) and Henry Thornton (in the early 19th century), developed detailed accounts of the channels through which increases in the money supply are translated into higher price levels. Indeed, the basic idea was understood by the ancients.

Irving Fisher, a U.S. economist writing in the first half of the 20th century, formalized these ideas in the "equation of exchange," MV=PT. This equation, probably the most famous in economics, states that the quantity of money (M) times its velocity of circulation (V) equals the price level (P) times the quantity of output or transactions in the economy (T). Fisher argued that V is determined by payments customs and technology, such as how long it takes to clear a check. He also argued that T depends on the total size of the real economy—its stock of physical capital and number of workers. Finally, Fisher argued that V and T would be relatively fixed in the short run. The conclusion was that price level changes—inflation—would be driven by changes in the money stock.

In a vigorous revival of interest in monetary economics starting in the 1950s, these basic ideas were greatly refined. The revival was led by the late Milton Friedman, professor at the University of Chicago and Nobel Prize winner in 1976. I studied under Friedman, which is an additional reason for me to have MV–PT plates. Moreover, although I had the same plates on my car in Rhode Island before coming to St. Louis, the St. Louis Fed has long been a leader in research in the monetarist, or Chicago, tradition. It was natural for me to apply for the same plates when I moved to St. Louis.

So, my MV–PT plates represent my graduate training, my profession, my conviction within my profession and my current job. If vanity plates are supposed to say something about a person, what better plates could I have?

Industrial Loan Companies Come Out of the SHADOWS

BY MICHELLE CLARK NEELY

A little-known segment of the U.S. financial services industry has been making big waves lately. Industrial loan companies (ILCs), also called industrial banks, have been around for almost 100 years, but only in the past couple of years have they been in the spotlight.

Most ILC owners are financial services firms, including some of the nation's leading companies: Merrill Lynch, American Express, Morgan Stanley and Goldman Sachs. The ILCs owned by these financial giants are among the industry's largest ILCs—averaging $30.5 billion in assets at year-end 2006—and enjoy considerable access to capital markets. Other ILCs that are owned by financial services firms are much smaller. Many ILCs—those owned by financial services firms and those owned by others—are narrowly focused on a single community, product line or customer type. For example, Wright Express Financial Services, a Utah ILC owned by Wright Express Corp., offers payment processing and information management services to the U.S. commercial and government vehicle fleet industry.

About one-quarter of ILCs are owned by nonfinancial companies. If commercial companies such as these want to own a financial institution, their only option is to obtain an ILC charter. These ILCs offer financial services that tend to directly support the products of their parent companies. Captive finance companies would fall into this category.

In the auto industry, General Motors, BMW, Volkswagen and Toyota all own ILCs, as does motorcycle manufacturer Harley-Davidson. General Electric, Pitney-Bowes, UnitedHealth Group and Target are other nonfinancial firms that control ILCs. More recently, The Home Depot—the world's largest home improvement specialty retailer—and Wal-Mart—the world's largest general retailer—have sought ILC charters.

Some of the recent attention and scrutiny can be traced to the industry's tremendous growth. Over the past two decades, the collective assets of these institutions have increased by more than 5,000 percent, and several ILCs rank among the nation's largest financial institutions. ILCs, formerly niche players in the financial marketplace, are an increasingly diverse lot, and many differ very little from commercial banks in terms of the products and services they offer.

But the reason ILCs are drawing so much attention now has less to do with their size and scope and more to do with who owns them—or wants to. The recent ILC applications by Home Depot and Wal-Mart have renewed long-standing national debates about the mixing of banking and commerce, the concentration of economic power and the proper role for federal banking supervisors.

Simple Beginnings

The first industrial loan companies appeared in the early 1900s. They were small, state-chartered institutions that made uncollateralized loans to low- and moderate-income workers who couldn't get such loans from banks. Because state laws at the time generally did

not permit ILCs to accept deposits, they funded themselves by issuing to investors certificates of investment or indebtedness, dubbed thrift certificates.

Over time, the Federal Deposit Insurance Corp. (FDIC) granted deposit insurance to ILCs on an individual basis. All ILCs became eligible for deposit insurance with the passage of the Garn-St. Germain Depository Institutions Act of 1982. Some states then began requiring ILCs to be FDIC-insured as a condition for keeping their charters. As a result, most ILCs became subject to federal safety and soundness supervision by the FDIC—a condition for deposit insurance—as well as the supervision mandated by their chartering states.

Five years later, Congress passed the Competitive Equality Banking Act (CEBA). This 1987 legislation was designed to close perceived loopholes in federal banking legislation—holes that permitted commercial firms to own so-called nonbank banks.[1] Among other provisions, CEBA broadened the definition of a bank under the Bank Holding Company Act (BHCA) to include any institution that was insured by the FDIC, which would seem to include most, if not all, ILCs. But ILCs—relatively small in number and size at the time—were essentially left alone in the legislation. Several states were permitted to grandfather existing ILCs and continue to charter new ILCs, whose owners—financial or commercial—would not be subject to the BHCA and the consolidated federal supervision that goes with it.[2] (Consolidated federal supervision refers to a federal agency's ability to assess the financial and managerial strength and risks within the consolidated organization as a whole, including the parent company and nonbank affiliates.)

Banking Behemoths?

Since 1987, there has been tremendous change in the ILC industry. (See charts.) Some ILCs now rank among the largest financial institutions in the country. Utah-based Merrill Lynch Bank USA, the nation's largest ILC, had more than $67 billion in assets at year-end 2006, putting it in the top 20 among all U.S. financial institutions. In total, 17 ILCs, or 28 percent of the industry, had more than $1 billion in assets at year-end 2006, compared with about 7 percent of commercial banks.

Because of the grandfathering provisions of CEBA, the ILC industry is concentrated in a handful of states. Utah is home to just over half of currently operating ILCs, with 32, followed by California (14), Nevada (five) and Colorado (four). Eight of the 10 largest ILCs are Utah-based, and the state's ILCs account for almost 90 percent of the industry's assets. The Government Accountability Office (GAO) reports that officials from the Utah Department of Financial Institutions credit Utah's "business friendly" environment, among other reasons, for the dominance and growth of the ILC industry in Utah.[3]

In addition to getting bigger, ILCs are broadening their scope. While a number of ILCs are still niche players that provide specialized products for corporate parents or narrow segments of customers, others offer a wide variety of loan and investment products and are virtually indistinguishable from commercial banks. Two important features of ILCs—permitted commercial ownership and a lack of consolidated federal supervision—set them apart from commercial banks, however, and it's those traits that have put the ILC industry in the limelight.

Obscure No More

Much of the current debate about the ILC industry can be attributed to the banking ambitions of two of the nation's largest retailers—Home Depot and Wal-Mart. Home Depot is seeking approval to buy Utah-based EnerBank, an ILC currently owned by CMS Energy Corp. EnerBank makes loans to consumers to finance home improvement projects, and Home Depot says it intends to keep the ILC's business plan and corporate structure intact. In its May 2006 Change in Control Application to the FDIC, Home Depot notes that "EnerBank has had significant success helping local, small contractors achieve business success. This fits with The Home Depot's desire to expand its relationships with contractors and trade professionals—especially the local, small contractors that are core to The Home Depot's business."

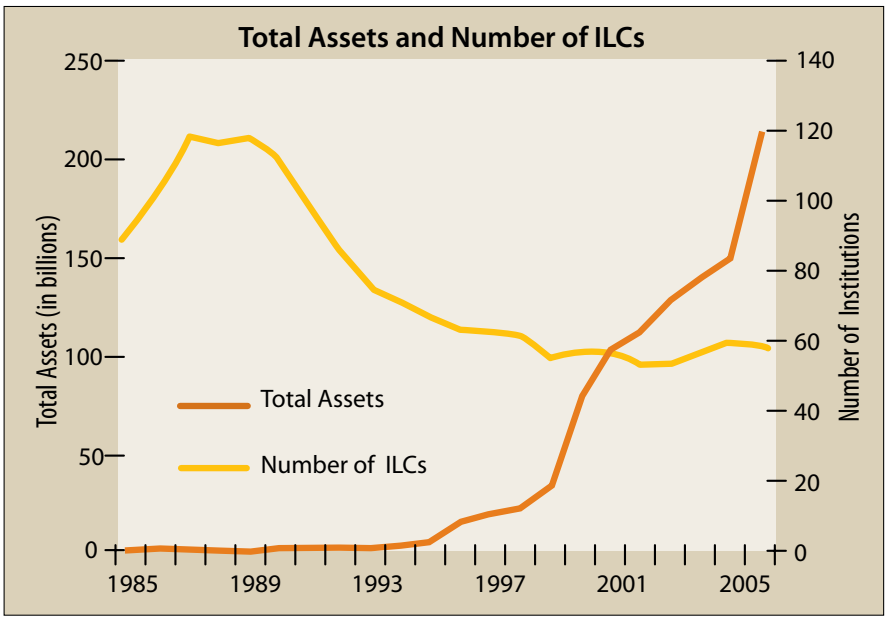
Wal-Mart, on the other hand, applied in 2005 to open a new ILC. It would be called Wal-Mart Bank and would also be based in Utah. In its application, the company stated that its ILC would not be engaged in retail banking—taking deposits from the public and making loans. Instead, Wal-Mart's ILC would be focused on processing electronic checks and debit and credit card payments, eliminating the need for a third-party processor; the savings would be passed on to Wal-Mart's customers through lower prices, the company said.

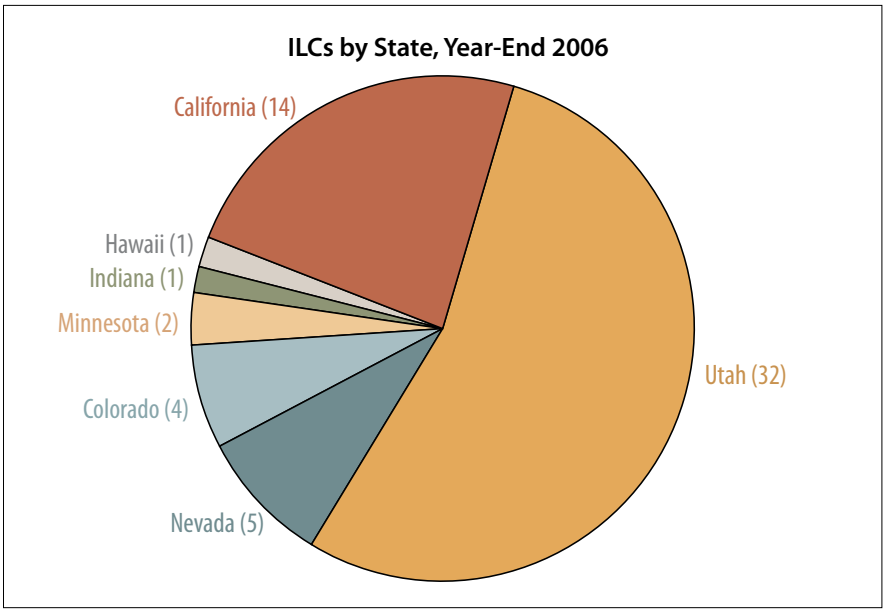
To say these applications were controversial is an understatement. Thousands of comment letters—the vast majority of them negative—were sent to the FDIC. The FDIC also held a series of public hearings about the Wal-Mart application in the spring of 2006. Members of Congress soon jumped into the fray. In June of last year, 98 members of Congress wrote a letter to the FDIC requesting a

moratorium on approvals for new, commercially owned ILCs. And in early July 2006, Reps. Barney Frank, D-Mass., and Paul Gillmor, R-Ohio, introduced a bill that would permanently bar commercial ownership of ILCs retroactive to June 1, 2006.[4] The legislation would also require ILCs to be subject to federal consolidated supervision similar to that mandated for bank holding companies.

The FDIC responded at the end of July 2006, issuing a six-month moratorium on approving ILC applications. In August, the agency issued a Notice and Request for Comment, seeking public comment on 12 questions related to ILC ownership and supervision. When the comment period ended, the FDIC had received more than 10,000 letters, including ones from Home Depot, Wal-Mart and a number of existing ILCs.[5] State legislators in more than a dozen states began debating, and in many cases enacting, legislation that would, in effect, bar banks from opening branches on the grounds of a commercial affiliate.[6]

Because Frank and Gillmor's ILC legislation wasn't acted on last year, they reintroduced it in late January 2007. Two days later, the FDIC announced it was extending the freeze on approvals of ILC applications by nonfinancial firms for one year. Financial firms that wished to charter or buy ILCs could still submit deposit insurance applications. That left four nonfinancial firms, including the giant retailers, in limbo. Wal-Mart ended up pulling its deposit insurance application in March. Home Depot recently reworked its deal with CMS to buy EnerBank, giving the retailer more time to get its ILC application through the FDIC.





Though the number of ILCs has declined by about half over the past 20 years, the industry's assets have grown exponentially. More than three-fourths of all ILCs are based in Utah and California.

Supervisory Blind Spot?

Concern about the growing size of the ILC industry had been building for several years prior to the Home Depot and Wal-Mart bids. Bankers' organizations, consumer groups, some banking regulators—including then-Fed Chairman Alan Greenspan—and several members of Congress had protested the exploding growth of a "parallel banking system." Requests from the ILC industry that it be included in proposed legislation that would allow banks to offer business checking accounts and to branch nationwide raised more unease. Once Wal-Mart and, to a lesser extent, Home Depot threw their hats into the ring, the protests grew louder and the issue took on front-burner status.

Most of the criticism being leveled at the ILC industry centers on commercial ownership and can be boiled down to its effects on competition and safety and soundness. Critics typically offer one or more of the following objections to commercial ownership. First, letting nonfinancial firms own ILCs runs counter to a long-standing—though somewhat porous—barrier in the United States between banking and commerce. Second, letting large commercial companies like Home Depot and Wal-Mart into banking will create economic conglomerates and could concentrate economic resources into the hands of a few. Third, some ILCs, unlike most other regulated financial institutions, are not subject to consolidated supervision at the federal level, creating safety and soundness, as well as competitive, issues.

The debate about the mixing of banking and commerce in the United States is a long-standing one. Although numerous exceptions (including commercially owned ILCs) have occurred, federal and state laws have attempted for the most part to keep the two separate. Those opposed to joint ownership of banking and nonfinancial businesses say a combination would produce risks that far

outweigh any benefits. Those perceived risks include conflicts of interest, a lack of impartiality in credit decisions, the creation of monopoly power and an expansion of the federal safety net.

Conflicts of interest could arise in a number of ways. First, a commercially owned financial institution could grant loans to its affiliates at below-market terms, resulting in distortions in the credit-granting process. Tying, which occurs when the provision of one product or service is dependent on the purchase of another product or service, is also a frequently cited concern, even though it is generally illegal in the United States for all businesses. The use of inside information to benefit one affiliate of a firm at the expense of outsiders is another potential conflict of interest.

Opponents of commercially owned ILCs also express worries about a concentration of economic power in banking that could seriously impair competition. Public and political distrust of large companies, especially banks, is deeply ingrained in American history and accounts for much of the impetus for keeping banking and commerce separate. Indeed, one of the major fears expressed about a Wal-Mart bank is the notion that it could become a local banking monopoly, putting community banks out of business in some small markets.

Giving commercial firms access to the federal safety net—deposit insurance and the Federal Reserve's discount window and payments system—is yet another perceived risk, especially if these firms are not subject to the same supervision and regulations imposed on financial firms with federally insured depository institutions. Here, the concern is that the bank could make loans or engage in other activities that would benefit an affiliate or the parent, but that would threaten the solvency of the bank. And because ILCs—which operate only under very

Wal-Mart: Always Controversy. Always.

Wal-Mart's 2005 application to the Utah Department of Financial Institutions (for an ILC charter) and to the FDIC (for federal deposit insurance) marked the fourth time that the retail giant has attempted to enter the banking business.

In 1999, the company tried to acquire Federal BankCentre, a small savings and loan institution in Broken Arrow, Okla. But this first venture was thwarted when Congress passed the Gramm-Leach-Bliley Act (GLBA) of 1999, which prohibited commercial companies from acquiring unitary thrifts like Federal BankCentre after May 4, 1999. Wal-Mart missed that deadline and dropped its bid.

Two years later, Wal-Mart announced plans to offer banking services to its customers through a joint venture with TD Bank USA, a subsidiary of Canada's Toronto-Dominion Bank. The companies planned initially to offer banking services in 100 Wal-Mart stores; Wal-Mart retail employees were going to be permitted to perform banking transactions in those stores. But the arrangement was torpedoed by the Office of Thrift Supervision (OTS) after the agency determined that the plan violated regulations designed to keep banking and commerce separate.

Undeterred, Wal-Mart sought permission in 2002 to buy Franklin Bank, an ILC based in Orange, Calif. As with its most recent attempt to charter an ILC in Utah, Wal-Mart stated that it planned to use the acquired ILC to process the millions of debit card transactions made in Wal-Mart stores each month. Buying Franklin would have given Wal-Mart access to the electronic payments system, permitting it to drop its third-party processors. The bid drew the attention of community bankers and other opponents, who lobbied the state legislature to pass a law that would prohibit the purchase. In the last two weeks of the 2002 legislative session, California enacted a law barring commercial firms from buying or chartering ILCs.

When Wal-Mart submitted its Utah ILC charter application in July 2005, the company's assurances that it had no intention of engaging in retail banking did nothing to quell the opposition. In response to some of the criticism, the company reversed its request to be exempt from the Community Reinvestment Act (CRA); executives said earlier that the law would not apply to Wal-Mart's ILC because it would not be dealing directly with the public.

The outcry about Wal-Mart's latest application prompted the FDIC to hold public hearings on Wal-Mart's deposit insurance application—a first in the agency's 74-year history. The hearings, held over three days, featured more than 60 presenters and drew hundreds of people. The vast majority of witnesses urged the FDIC to deny Wal-Mart's deposit insurance application. Though most objections were based on competitive and safety and soundness concerns, others focused on the company's labor policies and more issues unrelated to banking. Even former Utah Sen. Jake Garn, who helped boost the ILC industry in his home state, testified that he had asked Wal-Mart executives not to apply in Utah because he was afraid that a Wal-Mart application would create trouble for the whole industry.

Subsequent congressional hearings and an FDIC request for public comments about the ILC industry produced more of the same. Although proponents of commercial ownership of ILCs testified and outlined compelling arguments in favor of the status quo, they were vastly outnumbered by opponents who argued against it. Many expressed concerns that Wal-Mart would change its business plan and expand its banking operations after its ILC charter was granted, despite the company's assurances.

The heat was turned up again in January 2007, when federal legislation to bar commercial ownership of ILCs was reintroduced in Congress and the FDIC extended its freeze on approving ILC applications by commercial owners. More state legislatures began passing bills that would prevent commercially owned ILCs from branching into their states, and observers credit (or blame) Wal-Mart for the flurry of activity.

In mid-March 2007, Wal-Mart withdrew its deposit insurance application, citing the "manufactured controversy" over its ILC charter bid. Company officials said it would work to expand financial services—like check cashing and bill paying—that did not require a bank. Executives also pledged to continue Wal-Mart's partnerships with retail banks located in many of its stores and indicated that making loans through these third-party partnerships was a possibility.

The ILC bid was not in vain, however; spokesmen indicated that Wal-Mart's payment services providers had lowered their prices, recognizing that the company was serious about cutting these costs.

limited constraints—are not subject to the BHCA, their corporate parents are not supervised to the extent those of other insured financial institutions are, thus potentially creating an uneven competitive playing field.[7]

Though very few critics of ILCs in their current form find fault with past supervision of ILCs, Federal Reserve officials and others, such as the GAO, maintain there are potential problems with a lack of supervisory authority over ILC parents. In testimony before the U.S. House Subcommittee on Financial Institutions, Scott Alvarez, general counsel for the Federal Reserve Board (FRB), noted:

The primary federal bank supervisor for an ILC [the FDIC] may take enforcement action against the parent company or a nonbank affiliate of an ILC to address an unsafe or unsound practice only if the practice occurs in the conduct of the ILC's business. Thus, unsafe and unsound practices that weaken the parent firm of an ILC, such as significant reductions in its capital, increases in its debt or its conduct of risky nonbanking activities, are generally beyond the scope of the enforcement authority of the ILC's primary federal bank supervisor.

To solve such potential problems, some policymakers and ILC industry critics propose that the FDIC be given consolidated supervisory powers over ILC parents equivalent to the Federal Reserve's authority over bank holding companies and to the Office of Thrift Supervision's (OTS) authority over thrift holding companies; others believe such powers over ILCs should go to the Federal Reserve. The FDIC itself has asked for additional supervisory authority over ILC parents and has imposed new restrictions and conditions on recently granted deposit insurance applications by ILCs with financial parents.[8]

Proponents' Response

The ILC industry in its current form has a number of backers. Many economists argue that the wall between banking and commerce is not only artificial but unnecessary and may do more harm than good if resources are allocated inefficiently. There may be operational efficiencies—economies of scale and scope, as well as informational efficiencies—from combining commercial and financial firms that would reduce the costs of providing goods and services. Such combinations may produce greater product and geographic diversification for firms, lessening the chance of failure, as well as greater access to capital for firms of all types and sizes. Put succinctly, allowing new entrants in the financial services industry will likely increase competition, reduce costs and increase choices for consumers, proponents say.

In terms of safety and soundness, all ILCs are supervised by their chartering states, as well as by the FDIC; some ILCs are also subject to consolidated federal supervision by the OTS. The so-called bank-centric or bank-up approach to ILC supervision has its supporters. In this model, a bank's supervisor has examination and regulatory authority over the bank only and may have limited ability to examine and take supervisory actions against the bank's holding company or affiliates. Proponents argue that the current regulatory framework for supervising ILCs is more than sufficient to protect the deposit insurance fund and, hence, the taxpayers from losses. Though about two dozen ILCs have failed in the past 20 years, just two of the failures resulted in material losses to the deposit insurance fund.[9]

ILC industry backers point to the bankruptcy of Conseco Inc. in 2002 as an example of how the bank-up approach can and does work. Conseco's profitable Utah-chartered ILC, Conseco Bank, was sold at book value to GE Capital when the parent declared bankruptcy, with no loss to the FDIC.[10] Similarly, when Tyco International, a maker of electronics, plastics and fire and security products, went into financial distress and was embroiled in corporate scandals in 2002, it successfully spun off its Utah industrial bank, which still operates today as CIT Bank.

What's Next?

Wal-Mart's decision to withdraw its ILC application has taken some of the heat out of the firestorm over ILCs. Nevertheless, given the current climate, it appears likely that the ILC industry will be subject to more regulation, both at the ILC and parent company levels. The Frank-Gillmor bill, recently passed by the full House, would require federal consolidated supervisory authority over the industry and divide it among the OTS, FDIC, Federal Reserve and the Securities and Exchange Commission.

A Senate version of the House ILC bill was introduced by three senators in mid-May. Observers expect the bill to have a rougher going there, primarily because Utah Sen. Bob Bennett, the No. 2 Republican on the banking panel, staunchly opposes curbs on the ILC industry. Bill backers in both chambers have floated the idea of an exemption for automakers on a ban on commercial ownership, which may placate some lawmakers hesitant to pass the existing bill.

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ENDNOTES

1 A nonbank bank is a financial institution that either accepts demand deposits or makes commercial loans. Since the BHCA prior to CEBA defined a bank as an institution that does both, the holding companies of nonbank banks were able to avoid supervision by the Federal Reserve.

2 Grandfathered states include California, Colorado, Hawaii, Minnesota, Nevada and Utah. See GAO (2005) for more detail on CEBA and how it affected the ILC industry.

3 See GAO, pp. 18-21, for more information on the evolution of the ILC industry.

4 A commercial owner is defined as a company that derives more than 15 percent of its revenue from nonfinancial activity.

5 A large proportion of the letters were form letters. For example, more than 7,000 letters were from members of a group called "Close Loophole Advocates." Employees of Home Depot sent in almost 1,700 duplicate letters.

6 See Adler (March 13, 2007) for more detail on state efforts to curtail commercial ILCs.

7 To be exempt from the BHCA, ILCs cannot offer demand deposits that the depositor may withdraw by check or other means to make payment to third parties. Small ILCs (less than $100 million) and ILCs chartered before Aug. 10, 1987, are not subject to any restrictions to be exempt from the BHCA.

8 See Adler (April 23, 2007) for examples of new requirements and curbs imposed by the FDIC on recent ILC applications.

9 See GAO (2005), pp. 59-61.

10 See Blair (2005).

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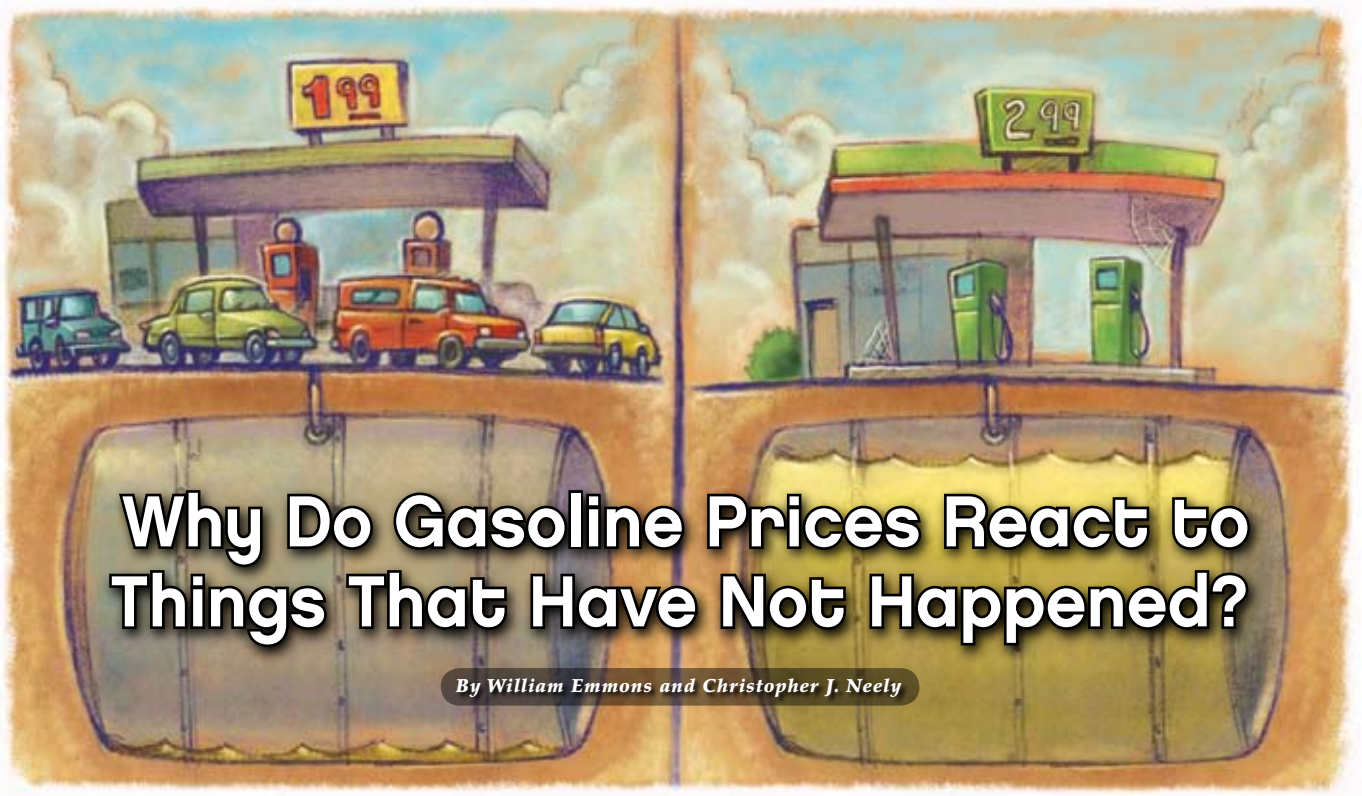


Why Do Gasoline Prices React to Things That Have Not Happened?

By William Emmons and Christopher J. Neely

Have you ever wondered why gasoline stations raise their prices in response to fears about future supplies of oil? You may have thought to yourself, "I know the gasoline in the station's underground storage tank was purchased before the world price increased. How can they raise the gas price now? The gasoline market must be rigged."

In fact, gasoline stations should raise their prices to reflect increased future costs of replacing their inventories. Prices act like engine or voltage regulators—they automatically speed up or slow down the flow of the commodity in order to maximize performance, or what economists call *allocative efficiency*.[1]

Oil and Gas, Here and There, Then and Now

To understand why U.S. gas prices respond now to things that might happen in the future, halfway around the world, one must understand how spot and futures prices for storable commodities, such as oil or gasoline, are related to each other.

The cost of oil comprises about half the cost of gasoline, but oil is the most volatile component; other factors, such as taxes and profit margins, do not change often.[2] The figure shows that while gasoline prices can diverge from oil prices for short periods because of seasonal demand, tax changes or other reasons, the two prices are closely linked over longer periods.[3]

Because oil can be transported anywhere, trading on global spot and futures markets determines the global price of a given grade of oil, aside from local taxes and transportation costs.[4] Oil can either be sold for immediate delivery or stored for sale in the future; so, firms adjust their inventories in response to news about the future supply and/or demand for oil. For example, an unsuccessful terrorist attack on a Saudi Arabian oil facility might create fears of further incidents that would actually disrupt supplies from the Persian Gulf. These fears would raise expected future prices and current spot prices, too. Current prices rise because the rise in the futures price will encourage firms to take oil off the spot market and sell it for delivery in the future. This inventory increase keeps the spot and futures prices moving up together.

Because oil is such an important component of gasoline, wholesale gasoline prices react instantly to changes in oil prices, including those caused by expectations of future events. The price at your local gas station will change nearly as quickly as the wholesale price.

The close connection between world oil prices and local gasoline prices can be seen by considering how two hypothetical competing gasoline stations in a small town would react to a sudden increase in the price of oil. On one quiet morning, both the Conch Gas station and the Pegasus Gas station were charging $1.999 per gallon of regular gasoline. They each had bought their inventories a few days before at a cost of $1.48 per gallon. With federal, state and local taxes combining for 50 cents per gallon, each station calculated that it would make about 2 cents per gallon at a retail price of $1.999.[5]

During the late morning, news of an unsuccessful terrorist attack on Saudi Arabian oil fields spurred widespread fears of cuts in future oil supplies. As frenzied trading on exchanges in New York, London and elsewhere bid up the world price of oil, the owner-manager of the Conch Gas station learned that wholesale gasoline prices for delivery next week had increased by $1 per gallon. "Folks aren't going to like this," she muttered to herself as she adjusted the prices on her gasoline pumps and climbed the ladder to raise her posted price to $2.999 per gallon. The owner-manager of the Pegasus Gas station had just finished changing his price to $2.999 when the two managers shrugged and nodded to each other across the street before they walked back into their respective stations.

Despite much grumbling at the price increases, sales at the Conch Gas and the Pegasus Gas stations proceeded much as before—both stations sold out their existing inventories right on schedule and then took delivery on a new load of gasoline at the new, higher wholesale prices. The station owners made a tidy, unexpected profit that week—$1.02 per gallon.

Are the Gas Stations Gouging Us?

Did the stations' simultaneous price changes the week before wholesale prices actually went up prove that Conch Gas and Pegasus Gas were colluding to gouge consumers? No. These competing station owners did not have much choice if they wanted to remain as profitable as their competitors and stay in business over the long haul. Let's consider why they raised their prices in response to announcements of wholesale price increases and what would have happened if they had not done so.

Suppose first that only Conch Gas had held its price at $1.999, while Pegasus Gas had raised its price to $2.999. Conch Gas obviously would have captured all of the traffic that day, but its storage tank would have run dry much sooner than expected. By the first or second day after the overseas disruption in the oil market, the owner-manager of Conch Gas might as well have gone on vacation—although she would have been better off if she worked throughout the week and charged the higher price. Meanwhile, the manager of Pegasus Gas—who took his vacation in the first two days of the crisis—returned to sell out his remaining inventory at $2.999 per gallon. In the end, the Pegasus Gas station made a much larger profit. The manager of Conch Gas will not make this pricing mistake again.

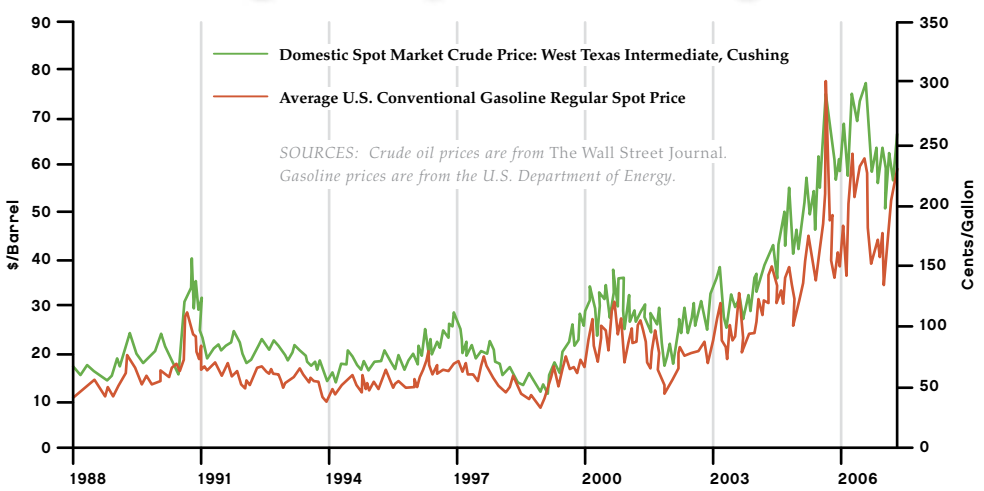
Now suppose that both Conch Gas and Pegasus Gas had decided to show home-town solidarity by keeping their prices at $1.999, at least until the new, higher-cost gasoline inventories arrived in a few days. Local residents certainly would have been appreciative, but so would all of the eager drivers from neighboring towns who would have driven in to enjoy "cheap" gas. In this case, consumers would have had to line up for gas, and both the Conch and Pegasus stations would have run dry before their replacement inventories arrived. Anyone in this town who was unfortunate enough to need gas on the third day of the crisis would have been out of luck. Taking the entire region into account, it is likely that about the same amount of gasoline would have been sold during the first days after the crisis as otherwise would have been the case. But there would have been wasteful driving by out-of-towners seeking cheap gas, while local residents would have been inconvenienced by the gas lines and the shortage when the Conch and Pegasus stations ran dry.

Consider one final possibility: What if all the gasoline stations in the state had agreed to keep their prices at $1.999 until higher-cost supplies started arriving? Even if the flow of out-of-state bargain hunters turned out to be small, a statewide shortage of gasoline would have been almost guaranteed in short order. How could this happen? Recognizing that gas prices were only temporarily low and were bound to rise soon, all rational owners of cars, trucks, tractors, off-road vehicles, lawn mowers or leaf blowers would fill up their tanks as quickly as possible. That is, any attempt to constrain the retail price of gasoline in the face of higher future prices simply induces a scramble among buyers to beat the price increase. Many people would make wasteful extra trips to top off half-full tanks, and others would be genuinely inconvenienced as shortages developed.

Thus, the simultaneous price increases by Conch and Pegasus Gas are not harmful price gouging at all. Although no one likes to pay more for gas, market-determined gasoline prices operate to prevent shortages and maximize economic efficiency.

William Emmons and Christopher J. Neely are both economists at the Federal Reserve Bank of St. Louis.

Oil and gasoline prices move together



ENDNOTES

1 Allocative efficiency means that consumers get the goods for which they are willing and able to pay.

2 See Energy Information Administration.

3 Although the figure shows just one grade of oil, West Texas Intermediate, the prices of all grades of oil tend to move closely together.

4 A spot market is one in which commodities are traded for near-term delivery—within a month for oil markets (Haubrich et al.). A futures market is one in which a commodity is traded for delivery on a specified future date, which could be months or years away. Major fuel users, such as airlines and trucking companies, often buy oil in futures markets to guarantee the cost of the fuel they will use. Oil suppliers are more likely to sell oil contracts in futures markets.

5 Other components of gasoline prices include taxes and the retail markup. The federal tax on gasoline is 18.4 cents per gallon; state and local taxes vary from 8 to 50 cents per gallon. The local service station makes about 1-4 cents of profit per gallon. See National Association of Convenience Stores.

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As Boomers Slow Down, So Might the Economy

By Kevin L. Kliesen

On Jan. 1, 2008, the first members of the baby boom generation will turn 62 and, thus, become eligible for some retirement benefits from the federal government. Countless studies have tried to estimate the fiscal implications of the pending retirement of this generation. Perhaps less known to the public are the implications for U.S. labor markets and, thus, the future growth rates of real GDP. Using a standard growth accounting framework, the aging of the U.S. population suggests weaker growth of real GDP going forward. Whether this occurs will depend crucially on future trends in labor productivity growth and, to a lesser extent, the evolving trend in the labor force participation rate.

The Economics of Growth Accounting

Economic theory holds that, in the long run, an economy's growth rate depends on factors such as population growth, saving and investment rates, technology, tax and regulatory policies, and consumer preferences for work and leisure.[1] To gauge an economy's potential for growth over longer periods of time, which implicitly takes into account these factors, economists sometimes employ a growth accounting framework. A simplified version of this framework is published each year in the *Economic Report of the President*. The growth accounting framework projects the percentage change in real GDP by adding up estimates of the percentage changes in: the adult population (those aged 16 and over), the participation rate of the working age population (ages 25 to 64) and aggregate labor productivity (GDP per worker).[2] Using conventional demographic assumptions that predict a significant reduction in the participation rate, the growth accounting framework shows that real GDP growth could slow dramatically in coming decades.

Population Growth

Currently, the Census Bureau projects that the annualized growth of the adult population will slow from a rate of 1.9 percent per year from 1970 to 2006, to 0.9 percent per year from 2007 to 2017, and then 0.8 percent per year from 2018 to 2028.[3] From this starting point, one can begin to get a sense of effects of the retirement of the baby boom generation by looking at the projected growth of the working age population over the next 10 to 20 years. According to the Census Bureau, growth of the working age population averaged about 2.25 percent per year from 1970 to 2006. However, over the next decade, its growth is slated to drop sharply. Between 2007 and 2017, growth is projected to average just 0.65 percent per year; from 2018 to 2028, growth is expected to average only 0.12 percent per year. At the same time, growth of the population age 65 and older is projected to accelerate, averaging 2.8 percent per year from 2007 to 2017 and by nearly 3 percent per year from 2018 to 2028.

Labor Force Participation Rates

The labor force participation rate is the percentage of the population 16 and older that is either employed or is actively seeking employment. Beginning in the early 1960s, the U.S. participation rate began to trend upward. From 1964 to 1997, the total participation rate rose from 58.7 percent to 67.1 percent, or by an average of 0.25 percentage points per year. An increasing percentage of women entering the labor force was a key factor in this increase. However, higher labor force participation rates did not materially boost aggregate growth over most of this period because of a sharp deceleration in labor productivity growth from about 1973 to about 1995. Since the late 1990s, though, the U.S. labor force participation rate has declined slightly, to 66 percent, but this effect has been more than offset by a reacceleration in labor productivity growth since about 1995.

A second factor that explained the upward trend in the aggregate labor force participation rate until the late 1990s was the aging of the population.[4] For example, the working age population as a percentage of the total resident

population rose from 44 percent in the late 1960s/early 1970s to about 53 percent by last year. It is projected to remain at that level until 2011 and then begin to fall to about 47 percent by 2050.

With growth of the retiree population increasing and the growth of the working age population decreasing, the labor force participation rate will probably trend lower. In their 2007 report, the trustees of the Social Security Administration (SSA) estimate that the participation rate will steadily decline to a little more than 59 percent by 2081.[5] Some developments could prevent this from occurring. First, an increasing percentage of the working age population must enter the labor force. Second, the baby boomers must either postpone retirement or continue to work part time. Third, the participation rates of women must resume their upward trend.

But these events are unlikely, for the following considerations.[6] First, the participation rates of women, particularly those who are married and with children, have declined in recent years. Second, a larger percentage of teens and young adults are attending post-secondary schools and staying in school longer. Finally, health and mortality considerations will eventually limit the participation rates of elderly baby boomers.

Productivity Growth

Productivity plays a crucial role in the growth accounting framework. In the long run, a nation's real GDP growth rate depends crucially on the growth of output per hour (productivity). The most common measure of labor productivity is output per hour in the nonfarm business sector. After increasing by an average of 1.4 percent per year from 1973 to 1994, the nation's labor productivity growth rate began to accelerate beginning around 1995. From 1995 to 2006, labor productivity increased at an average annual rate of 2.7 percent. By most accounts, this acceleration stemmed from innovations in information and communication technology equipment.[7] Recently, however, labor productivity growth has decelerated sharply, from 4.1 percent in 2002 to only 1.6 percent in 2006; last year's increase was the smallest since 1997. The steady slowing in labor productivity growth is unsettling and perhaps raises questions about its underlying strength. However, the most recent Survey of Professional Forecasters projects that labor productivity growth will increase by an average of 2.2 percent per year over the next 10 years.[8]

Adding It Up

As shown in the table, the growth accounting framework projects that real GDP growth will slow from an average of 3 percent per year from 1990-2006 to 2.5 percent per year from 2007-2017 and then to 2.2 percent per year from 2018-2028.[9] These estimates are based on the census population projections and the SSA labor force participation rate projections noted earlier, along with the assumption that the rate of aggregate productivity growth will remain at its 1990-2006 average.

It is apparent that faster aggregate productivity growth can also mitigate the projected slowing in real GDP growth. However, there are several factors that could prevent this from occurring. First, productivity growth may slow, as older, more experienced workers are replaced with younger, less experienced workers. Second, if tax rates are increased to address the looming fiscal crisis stemming from the retirement of the baby boomers, then capital spending (investment) by firms might drop, putting a brake on productivity growth. A related effect could occur if taxes or regulations are implemented to address climate change. In this case, higher energy taxes would render obsolete some portion of the nation's stock of capital goods, much as the oil price shocks of the 1970s did. Third, U.S. saving rates have been extraordinarily low. In fact, the personal saving rate was negative in 2005 and last year. Unless reversed, negative personal saving rates will limit capital formation and productivity growth.

From a pure growth accounting standpoint, real GDP growth rates are projected to slow to rates last seen from 1973 to 1983 (2.25 percent per year). Whether this occurs will depend on future productivity growth rates and labor force participation rates—including those people who choose to continue working in "retirement."

Kevin L. Kliesen is an economist at the Federal Reserve Bank of St. Louis. Joshua A. Byrge provided research assistance.

Accounting for Annual Growth, 1990 to 2028
Percent changes, annual rate per year

	1990-2006	2007-2017	2018-2028
Population	1.24	0.91	0.83
+ LFP rate	-0.03	-0.25	-0.40
+ Productivity	1.82	1.82	1.82
= Real GDP	3.0	2.5	2.2

NOTE: Projections of the labor force participation rate (LFP) are based on the cost assumptions used in the Social Security Administration's 2007 Trustees Report.

ENDNOTES

1 Economists typically measure economic growth from a long-run perspective as the growth of real GDP per capita.

2 Monetary policy plays no role in boosting the economy's long-run rate of growth in this supply-side framework. Instead, central banks can only influence the price level in the long run (that is, the inflation rate).

3 The U.S. Census Bureau formally counts the nation's population every 10 years. Between these counts, the Census Bureau publishes population estimates based on the number of births, the number of deaths and net (total) migration that occur each year. From these estimates, long-run population projections are made based on assumptions like future trends in fertility and death rates and in immigration.

4 Briefly, if the participation rate of a specific age group changes, or the share of a certain age group within the total population (i.e., the population weight) changes, then the labor force participation rate can change significantly.

5 This would be the lowest rate since 1966, when the participation rate averaged 59.2 percent. The SSA participation rate is based on the projection consistent with the trustees' intermediate cost projections for Social Security benefits.

6 See Aaronson et al. (2006) and Juhn and Potter (2006).

7 See Anderson and Kliesen (2006).

8 See Federal Reserve Bank of Philadelphia (2007). The growth accounting framework uses *aggregate* productivity, which is based on total GDP; nonfarm business sector output is about 77 percent of total GDP.

9 Actual real GDP growth also averaged 3 percent per year from 1990 to 2006.

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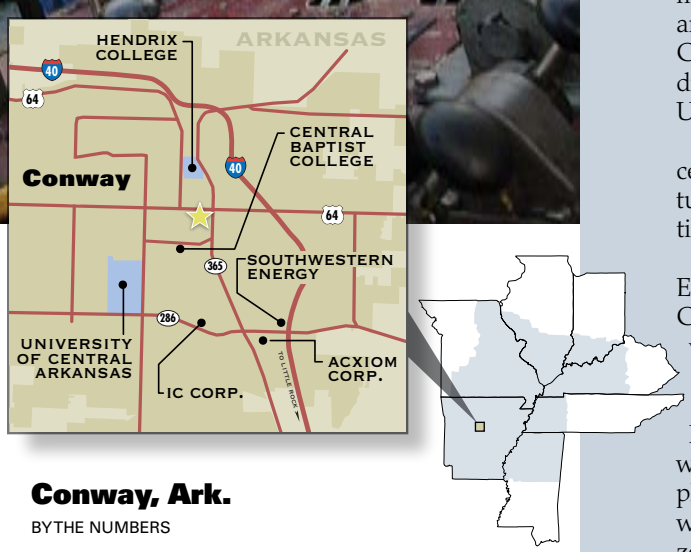
Community Profile

By Glen Sparks

CONWAY

Good fortune runs in a strip across north-central Arkansas, anywhere



Conway, Ark.

BY THE NUMBERS

Population	City 51,999 (2005)
	County 97,739 (2005)
County Labor Force	25,761 (January 2007)
County Unemployment Rate	4.6 percent (January 2007)
County Per Capita Income	$25,534 (2004)

TOP FIVE EMPLOYERS

Acxiom	2,000
University of Central Arkansas	2,000
Conway Regional Medical Center	1,300
IC Corp	1,279
Conway Human Development Center	1,200

ABOVE: Curtis Henry operates a drill at a SEECO Inc. rig site in the middle of a hay field 30 miles north of Conway.
RIGHT: Workers put the finishing touches on a school bus at IC Corp.
MIDDLE: A network engineer works in the Network Operations Center at Acxiom.
FAR RIGHT TOP: At Hendrix College, a covered swimming pool goes up at the new Wellness and Activities Center. Hendrix plans to build a mixed-use community with shops, restaurants and apartments in the wooded area behind the pool.

Drills chew through the earth toward this good fortune, aka the Fayetteville Shale Play, a rich natural gas deposit that stretches 100 miles long and 20 miles wide. (Shale is a rock that yields gas after being put under extreme pressure. "Play" is an energy industry term that describes a portion of the exploration and production cycle after companies identify an area with potential oil or gas reserves.)

"Conway seems to be the heart" of the play, says John Thaeler, senior vice president of SEECO Inc., a subsidiary of Houston-based Southwestern Energy Co., which holds about 1 million acres in mineral leases throughout the state. "This is going to be a huge boost to the economy."

A recent study conducted by the University of Arkansas College of Business and paid for by Southwestern Energy concluded that the play will add $1.6 billion to the state economy this year, employ more than 6,600 workers and generate nearly $106 million in state and local tax revenue.[1]

"The play's greatest benefit to the state of Arkansas is that it will provide an economic stimulus and will diversify the employment base, reducing the dependence on manufacturing and retail, and providing many jobs with above-average pay," economist Jeff Collins predicted when the study was released. Collins served as director of the Center for Business and Economic Research at the University of Arkansas and now runs a consulting firm.

In Conway, the play benefits a city long noted as an education center (see sidebar), but one that also boasts a strong manufacturing sector. This Little Rock suburb features a blend of traditional and high-tech businesses.

The natural gas boom began in Arkansas after Southwestern Energy successfully drilled test wells in the Conway area in 2004. Chesapeake Energy, based in Oklahoma City, followed Southwestern to Conway, as did natural gas company suppliers like National Oilwell Varco (NOV) and Schlumberger.

Southwestern opened a Conway office in 2005 with 12 people. Now, the firm has more than 400 employees working in Conway. Southwestern plans to invest nearly $1 billion in the shale play this year, in part by building between 400-450 horizontal wells, which drill down to the gas reservoir and then move horizontally through the gas-bearing zone.

Landowners who allow energy companies to explore for gas on their property get a part of the cut—one-eighth to one-fifth of the sales profit once the gas goes to market.

Companies usually expect about 20 years of production from a working well, but that estimate is subject to considerable uncertainty.

"You really don't know how much these wells will produce, or how the technology might advance and let you produce even more," Thaeler says. "We have wells in Texas that have been pumping out gas for more than 30 years."

School Bus Capital

Long before energy firms began drilling in Conway, workers here built school buses. IC Corp. makes more school buses than any other company in the United States, says IC's plant manager,

Makes Play for Economic Boom

from 1,500 feet to 6,500 feet below the ground.

Ed Hartung. In 2007, the company expects to complete as many as 8,000 school buses, plus some prison buses and tour buses.

With more than 1,200 employees, IC is the largest manufacturer in town. (Other large manufacturers include Virco, with 821 employees; Kimberly-Clark, 481; and Snap-on tools, 472.)

Founded as Ward School Bus Manufacturing in Conway in 1933, IC is a wholly owned subsidiary of International Truck and Engine, which, in turn, is part of Navistar, based in the Chicago area.

A typical wage for IC assembly-line workers, who are represented by the local United Auto Workers union, is $15.75 an hour. "For the person in Conway who has a high school education and who is looking for a good wage and great benefits, we fill that niche," Hartung says.

Conway High-Tech

Acxiom, founded in 1969, grew out of the bus builder's data processing department. The company manages data for an international clientele, helps companies analyze and build on their customer base, and identifies the best strategies for information management. Acxiom has branch offices in the United States and in 10 countries around the globe, with 7,000 employees worldwide.

In late May, a private equity firm announced that it wanted to buy Acxiom. Because the deal won't close until mid-September, it's hard to tell what impact the buyout will have on the company or Conway, says Jerry Adams, Acxiom's economic development chief and director of community relations.

Adams also serves as chairman of a statewide economic development group, Accelerate Arkansas. He says that Acxiom is a model for the type of high-tech, white-collar businesses that Arkansas wants to attract.

Brad Lacy, head of the Conway Development Corp., agrees. "The natural gas industry has gotten big here over the last couple of years, but that's like a present given to us," Lacy says. "We've shown that we can grow a major technology firm here, and we want more of that."

The city population has grown by almost 9,000 people since 2000, according to Census Bureau figures. Over the past several years, Conway also has added the 650,000-square-foot Conway Commons mall and several chain restaurants. Downtown has undergone revitalization, including a $2.5 million renovation of the historic Halter building, constructed in 1917.

The growth in Conway notwithstanding, Acxiom decided in 2000 to transfer its corporate headquarters to Little Rock, which makes it easier to attract and retain top executives, Adams says. About 700 Acxiom employees work in Little Rock. Acxiom still has about 2,000 employees in Conway on a 12-building campus.

"Getting workers to come to Conway is becoming easier all the time," says Adams, who is originally from St. Louis. "It's one of those things where you still have the small-town atmosphere, but there has been so much growth in recent years, and the big city (Little Rock) is just 30 minutes away."

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

[1] See http://cber.uark.edu/data/FayettevilleShaleEconomicImpactStudy.pdf.

Hendrix College Embraces the City Life

Hendrix College is one of a handful of colleges and universities across the country that hope to attract more students by adding a bit of the city life to their rural or suburban campuses.

That's the idea behind The Village at Hendrix, a retail and residential space that the liberal arts school is developing in Conway. Hendrix College plans to break ground late this year or early next year on the approximately 93-acre development, which will be located on the edge of campus.

Plans call for 170,000 square feet of retail space, plus 190 single-family houses, 130 townhouses, 160 apartments and 30 loft-style units. The development should appeal to students, but also to faculty, senior citizens and anyone else who prefers to walk, not drive, to the dentist or supermarket.

"The Village at Hendrix is one of the new urban communities that put amenities within walking distance," says Scott Schallhorn, the vice president and general counsel for Hendrix and the CEO of The Village at Hendrix LLC.

A combination of special improvement district bonds and private financing will pay for the $235 million project. Hendrix will contribute about $10 million in Phase I, which includes much of the infrastructure work. Individual home-building firms will finance much of the project, Schallhorn says.

Hendrix, with an enrollment of about 1,100 students, is one of three colleges in Conway, along with Central Baptist College, which has about 500 students, and the University of Central Arkansas, which has approximately 12,400.

Central Arkansas' enrollment has risen by almost 5,000 since 2001, says Warwick Sabin, the school's vice president of communications. He credits this dramatic rise to an aggressive marketing campaign begun by Lu Hardin, president since 2001. Hardin has done several TV ads and other promotions as a way to attract more students to UCA.

The school is also making more scholarships available to incoming freshmen, Sabin says, and interest is up in the school's health sciences programs, such as nursing, physical therapy and occupational therapy.

Roger Lewis, an economist at Central Arkansas, says that the three Conway schools help keep the local economy strong. Graduates help fill jobs at Acxiom (see main article) and other firms. Students never seem to run out of money, Lewis adds.

"The kids seem to spend, spend, spend," Lewis says. "Because there are so many schools here, we have so much to do. We even have a symphony in town."

Population, Sprawl and Immigration Trends in Eighth District Metro Areas Vary Widely

By Michael R. Pakko and Howard J. Wall

Recently, the Census Bureau released estimates of metro-area populations as of July 1, 2006. The latest data are consistent with the usual observation that population is flowing from the Snow Belt to the Sun Belt, with slower growth rates concentrated in the East and Midwest and more rapid growth rates concentrated in the West and South. As a region that straddles the Midwest and Midsouth, the Eighth Federal Reserve District experienced a wide range of population changes across its metro areas.

Taking the totals for all metro areas in the District, the 2006 population estimate was 8.6 million, representing an increase of approximately 460,000 residents since 2000 (a growth rate of 5.6 percent). By comparison, the population of the United States as a whole experienced an increase of 6.4 percent over the period. Among the four major metro areas in the District, only Little Rock, Ark., saw faster-than-average population growth: 6.9 percent. Louisville, Ky.-Ind., and Memphis, Tenn.-Ark., grew by 5.2 percent and 5.8 percent, respectively, while the St. Louis, Mo.-Ill., metro area population expanded by only 3.9 percent.[1]

Some of the smaller metro areas in the District were among the fastest growers. Most prominently, the Fayetteville, Ark.-Mo., metro area grew by 21.3 percent since the beginning of the decade, putting it among the 20 fastest-growing metro areas in the country. Other rapidly growing metro areas in the District include Springfield, Mo. (10.5 percent); Bowling Green, Ky. (8.8 percent); Hot Springs, Ark. (8.1 percent); and Columbia, Mo. (7.1 percent). At the other end of the spectrum, the population of Pine Bluff, Ark., fell by 3.4 percent—the only metro area in the District to have experienced a population decline over the period.

Suburban Sprawl

The data for metro areas as a whole obscure some significant patterns of growth within the metro areas themselves, particularly the ongoing movement of population from central cities and inner suburbs to outlying suburbs. The St. Louis metro area offers a prime example of this trend. Since the beginning of the decade, the population of the city of St. Louis rose by only 1.6 percent, while St. Louis County, which is home to the suburbs immediately abutting the city, experienced a decline of 1.6 percent. Counties containing the second and third layers of suburbs beyond the central city grew very rapidly, however: Lincoln, Mo. (28.7 percent), Warren, Mo. (21 percent), St. Charles, Mo. (19.3 percent) and Monroe, Ill. (15.4 percent).

Similarly, in the central counties of the Little Rock (Pulaski), Memphis (Shelby) and Louisville (Jefferson) metro areas, which include central cities and inner suburbs, population expanded by less than 2 percent, meaning that the bulk of metro area population growth took place in outlying suburbs. In the Little Rock area, growth was strongest in Lonoke (19.1 percent), Faulkner (17.1 percent) and Saline (12.6 percent) counties. In the Memphis area, two Mississippi counties—De Soto (35.0 percent) and Tunica (12.9 percent)—and two Tennessee counties—Fayette (25.3 percent) and Tipton (11.9 percent)—grew much faster than the rest of the metro area. The population of Spencer County, Ky., has been the fastest growing county in the Louisville metro area (and, indeed, in the entire Eighth District), having expanded by 40 percent since 2000. Another five counties in the Kentucky part of the Louisville metro area also saw double-digit population growth: Oldham (19.7 percent), Shelby (19.1 percent), Bullitt (19 percent), Nelson (12.3 percent) and Trimble (11.7 percent).

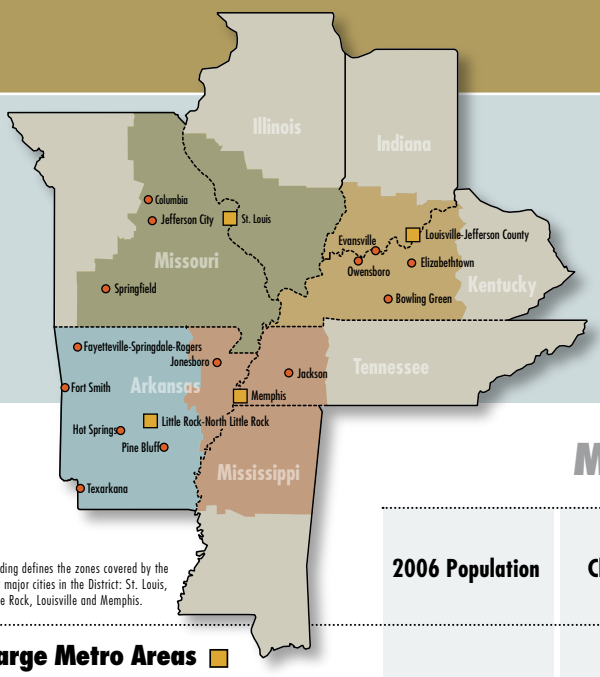
This movement toward outlying suburbs is evident even in some of the smaller metro areas in the District. For example, Greene County, Mo., which includes the city of Springfield, grew by 6 percent, while the nearby counties of Webster and Christian expanded by 14.4 percent and 29.9 percent, respectively. Similarly, the fastest growing county in the Fort Smith, Ark., metro area is Crawford County rather than its own Sebastian County, and the most rapidly growing county in the Jefferson City, Mo., metro area is Callaway County instead of its own Cole County.

International and Domestic Migrants

Data on net international and internal (domestic) migration across District metro areas, also published by the Census Bureau, show no clear pattern. In fact, there is not even a clear pattern in whether the two types of migration are negative or positive net contributors to population growth at the metro-area level.

In the St. Louis metro area, for example, international migration added 26,682 residents over the decade, offsetting a 23,449 outflow of domestic migrants. In Memphis, on the other hand, net inflows have been positive for both types of migrants, with a net inflow of 13,040 international migrants and 5,934 domestic migrants. Louisville also saw positive net flows for both types of migrants, but it was domestic migration that was predominant (a net inflow of 16,776), although international migrants did account for a large portion of the population increase (a net inflow of 11,803). This pattern was more pronounced for Little Rock, where the net increase in population due to domestic migration was about 4.5 times that due to international migration.

For the central counties of these four metro areas, there *was* a clear pattern of the relative importance of the two types of migration. In each case, positive net international migration helped to offset the large net out-migration to other parts of the area or the country. In fact, if it weren't for international migration, these central counties would have seen overall population losses. The city of St. Louis saw a net international inflow of 11,050 and a net domestic outflow of 52,859.[2] Shelby



Shading defines the zones covered by the four major cities in the District: St. Louis, Little Rock, Louisville and Memphis.

METRO AREA POPULATION

	2006 Population	Change Since 2000	Percentage Change	International Migration	Internal (Domestic) Migration
Large Metro Areas ■					
St. Louis, Mo. - Ill.	2,803,024	104,337	3.9	26,682	–23,449
Little Rock-North Little Rock, Ark.	652,834	42,316	6.9	3,710	17,027
Louisville-Jefferson County, Ky. - Ind.	1,222,216	60,241	5.2	11,803	16,776
Memphis, Tenn. - Miss. - Ark.	1,274,704	69,500	5.8	13,040	5,934
Small and Medium Metro Areas ●					
Bowling Green, Ky.	113,320	9,154	8.8	2,455	3,550
Columbia, Mo.	155,997	10,331	7.1	2,927	1,488
Elizabethtown, Ky.	110,878	3,331	3.1	–38	–1,147
Evansville, Ind. - Ky.	350,356	7,541	2.2	1,520	854
Fayetteville-Springdale-Rogers, Ark. - Mo.	420,876	73,831	21.3	9,957	43,199
Fort Smith, Ark. - Okla.	288,818	15,648	5.7	3,763	4,327
Hot Springs, Ark.	95,164	7,096	8.1	444	8,148
Jackson, Tenn.	111,937	4,560	4.2	1,027	796
Jefferson City, Mo.	144,958	4,906	3.5	859	506
Jonesboro, Ark.	113,330	5,568	5.2	886	2,132
Owensboro, Ky.	112,093	2,218	2.0	307	–868
Pine Bluff, Ark.	103,638	–3,703	–3.4	443	–5,871
Springfield, Mo.	407,092	38,718	10.5	1,489	28,532
Texarkana, Texas - Texarkana, Ark.	134,510	4,761	3.7	516	2,771

SOURCE: U.S. Census Bureau

County (Memphis) experienced a net inflow of 11,795 international migrants and a net outflow of 35,862 domestic migrants. Jefferson County (Louisville) had an inflow of 9,638 international migrants and a domestic outflow of 17,310. In Little Rock, Pulaski County had a net inflow of 2,843 international immigrants to partly offset its net domestic outflow of 11,373 residents.

International migration has been important for some of the smaller- to medium-sized metro areas as well, especially those that experienced the most-rapid growth. Metro areas in which international migration has accounted for more than 20 percent of the area's population growth include Bowling Green, Columbia, Evansville, Fort Smith and Jackson. It is worth noting, however, that the two fastest growing metro areas in the District—Fayetteville and Springfield—owe most of their population growth to net migration from the rest of the country. For Fayetteville, large net domestic migration accounted for 59 percent of the total change in population, while the corresponding number for Springfield was 74 percent.

Michael R. Pakko and Howard J. Wall are both economists at the Federal Reserve Bank of St. Louis. Joshua Byrge, a research associate, provided research assistance.

ENDNOTES

1 The numbers for the St. Louis metro area do not include the portion of Crawford, Mo., county that lies within the metro area border. Also, St. Louis city successfully appealed its initial population estimate, which had indicated a population decline. In this article, the data on total population changes in the St. Louis metro area and the city of St. Louis reflect the revised estimate.

2 These numbers are from the original estimates, not the revised estimates, which are not yet available at this level of detail.

The Economy Continues to Take a Punch

BY KEVIN L. KLIESEN

U.S. real GDP growth was quite weak in the first quarter, a continuation of the below-trend growth that has been seen for the past year. Still, a return to trend-like growth by the end of the year remains the most likely scenario. At the same time, resurgent crude oil and gasoline prices since mid-January have caused an unwelcome rebound in headline inflation pressures. The headline measure that excludes food and energy prices (core inflation) has eased modestly since the third quarter of 2006, providing Fed policymakers some degree of comfort.

From mid-January to late May 2007, U.S. average retail gasoline prices rose by 48 percent to $3.22 per gallon. Driven by seasonal demand, by refinery outages that have dramatically reduced inventories and by strong global demand for gasoline, retail gasoline prices are expected to hover around $3 per gallon this summer. The government's forecast of an above-average hurricane season this summer raises the risk that energy prices could increase further. Forecasters, nevertheless, expect Consumer Price Index (CPI) inflation to average about 2.5 percent during the second half of this year, about one percentage point less than that projected for the first half of the year.

Price pressures have eased modestly outside of the food and energy complex. Since September 2006, the year-to-year percent change in the core Personal Consumption Expenditures (PCE) inflation rate has declined by a little more than 0.25 percentage points to 2 percent. Although the Federal Open Market Committee (FOMC) expects some additional moderation, forecasters are more skeptical. The Survey of Professional Forecasters (SPF) expects that the core PCE will increase by 2.1 percent this year and next.

Rising energy prices, the housing correction, and an unexpected weakening in the pace of business equipment and software purchases have been key factors pushing the pace of real GDP over the past year below its trend rate of growth (roughly 3 percent). This slowdown culminated with an anemic 0.6 percent growth rate in the first quarter of this year, the smallest increase in a little more than four years and well short of the 2.5 percent gain posted in the fourth quarter of last year. Forecasters, by and large, still see the economy steadily gaining strength after the weak first-quarter performance.

Compared with their projections at the end of last year, SPF forecasters have become a bit more pessimistic about the strength of real personal consumption expenditures for the remainder of this year, perhaps in response to increased gasoline prices. The unexpected weakness in business capital outlays (equipment and software) over the past year, as well as uncertainty in energy markets, has also caused some forecasters to expect a somewhat weaker rebound in real business fixed investment for the rest of this year than what was expected at the end of last year. In any event, business capital spending appears to be improving after declining during the fourth quarter of last year, as evident by the strong rebound in new orders for manufactured nondefense capital goods (excluding aircraft) in March and April.

Some signs of stabilization have appeared in the housing sector, as seen by a modest rebound in housing starts since January and the sharp jump in new-home sales in April. That said, home builders are still trying to pare the sizable inventory of unsold homes, chiefly through price reductions or sales incentives. Accordingly, the stabilization of the housing market might be several months away, but it is nonetheless a key factor in the expected return to trend-like real GDP growth toward the end of this year. Also key is the continued favorable outlook for commercial construction spending and the foreign demand for U.S. goods and services.

Labor market conditions have weakened modestly this year. First, payroll employment gains thus far in 2007 have averaged only 133,000 per month, about 55,000 per month less than last year. Second, labor productivity growth in the nonfarm business sector has slowed from 4.1 percent in 2002 to 1.6 percent last year. This development, which is being watched closely, has caused some forecasters to lower their estimate of potential real GDP growth to below 3 percent. In the short run, the threat posed by higher energy prices could intensify if labor productivity growth weakens further. If so, core inflation may not moderate as much as the FOMC expects. In view of the consensus forecast for real GDP, policymakers are likely to remain focused on keeping inflation and inflation expectations in check.

Kevin L. Kliesen is an economist at the Federal Reserve Bank of St. Louis. Joshua A. Byrge 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

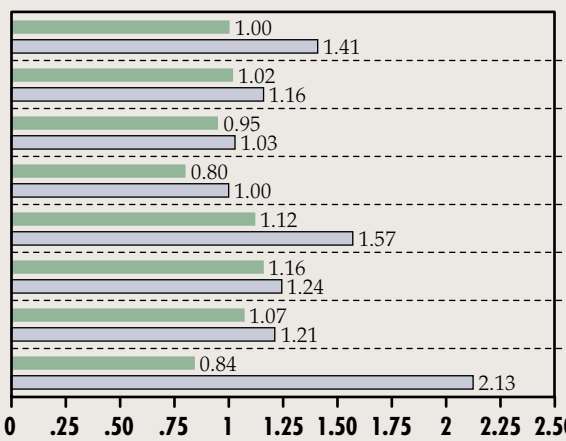
Commercial Bank Performance Ratios

FIRST QUARTER 2007

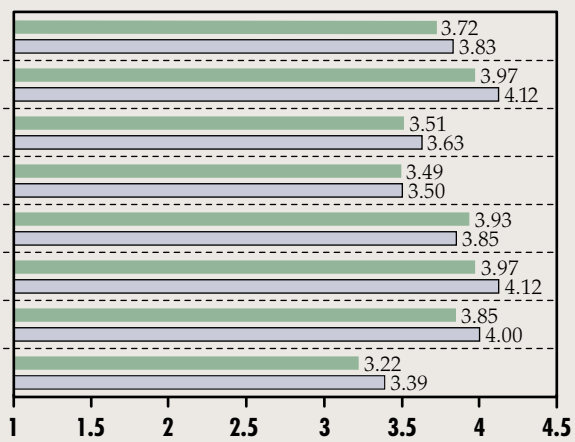
U.S. Banks by Asset Size

	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*	1.24	1.11	1.02	1.22	1.12	1.25	1.19	1.26
Net Interest Margin*	3.34	4.16	4.17	4.06	4.12	3.87	3.99	3.10
Nonperforming Loan Ratio	0.82	0.86	0.90	0.74	0.82	0.68	0.75	0.85
Loan Loss Reserve Ratio	1.17	1.26	1.29	1.23	1.26	1.24	1.25	1.14

Return on Average Assets*

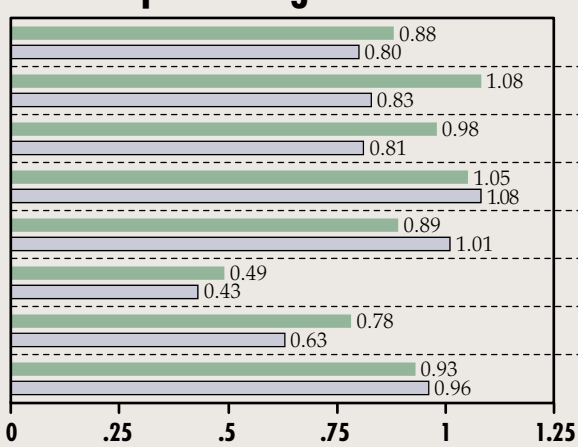


Net Interest Margin*

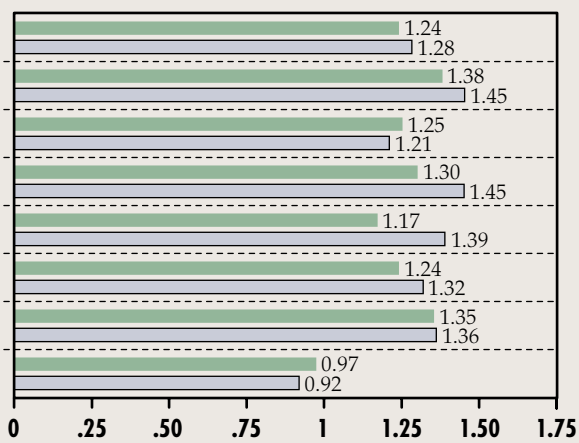


Eighth District
Arkansas
Illinois
Indiana
Kentucky
Mississippi
Missouri
Tennessee

Nonperforming Loan Ratio



Loan Loss Reserve Ratio



First Quarter 2007 First Quarter 2006

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

FIRST QUARTER 2007

	UNITED STATES	EIGHTH DISTRICT	ARKANSAS	ILLINOIS	INDIANA	KENTUCKY	MISSISSIPPI	MISSOURI	TENNESSEE
Total Nonagricultural	1.5%	0.9%	0.8%	1.0%	0.2%	0.8%	2.1%	1.1%	1.0%
Natural Resources/Mining	7.5	2.6	12.7	–1.7	0.5	3.0	4.8	–3.1	0.0
Construction	0.3	1.8	0.9	1.2	–0.4	–0.2	5.9	0.4	6.6
Manufacturing	–0.7	–1.7	–3.8	–0.6	–2.0	–0.9	–2.3	–1.8	–2.6
Trade/Transportation/Utilities	0.8	0.9	1.0	0.5	1.0	0.4	1.8	1.5	1.0
Information	0.9	0.5	3.4	–0.4	0.5	1.6	–2.4	–0.3	3.0
Financial Activities	1.8	1.1	2.1	1.3	0.4	1.8	–0.2	1.7	0.5
Professional & Business Services	2.7	1.7	1.4	2.0	1.1	1.5	2.1	1.9	1.1
Educational & Health Services	2.7	2.2	2.7	2.5	1.0	1.9	4.0	2.3	2.3
Leisure & Hospitality	3.5	2.8	1.3	3.1	0.6	2.1	7.6	3.2	3.4
Other Services	0.6	0.5	2.3	0.4	0.8	0.4	–0.1	0.1	0.8
Government	1.3	0.5	1.8	-0.2	0.5	0.9	2.3	0.2	0.1

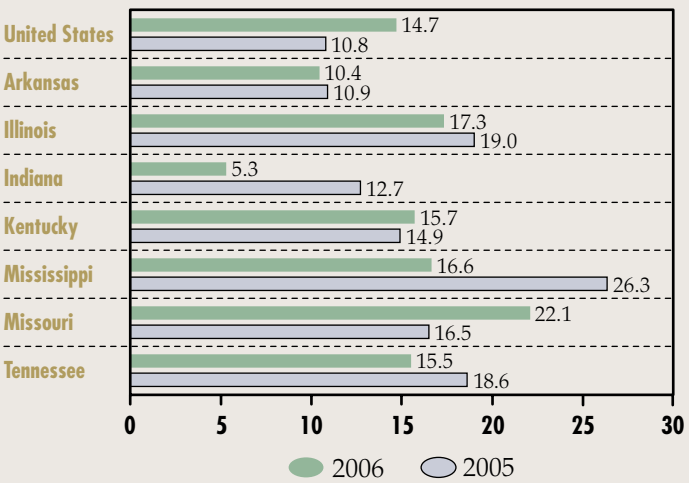
Unemployment Rates

PERCENT

	I/2007	IV/2006	I/2006
United States	4.5%	4.5%	4.7%
Arkansas	5.0	5.4	5.0
Illinois	4.5	4.1	5.0
Indiana	4.8	4.8	5.0
Kentucky	5.6	5.6	6.0
Mississippi	6.6	6.9	7.1
Missouri	4.8	4.9	4.7
Tennessee	4.8	5.0	5.2

Exports

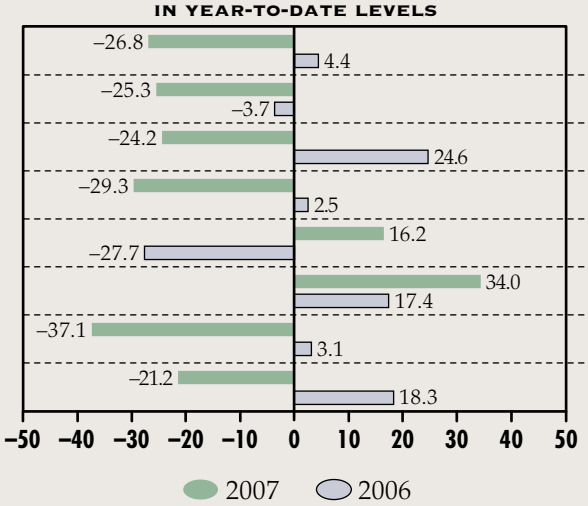
YEAR-OVER-YEAR PERCENT CHANGE



FIRST QUARTER

Housing Permits

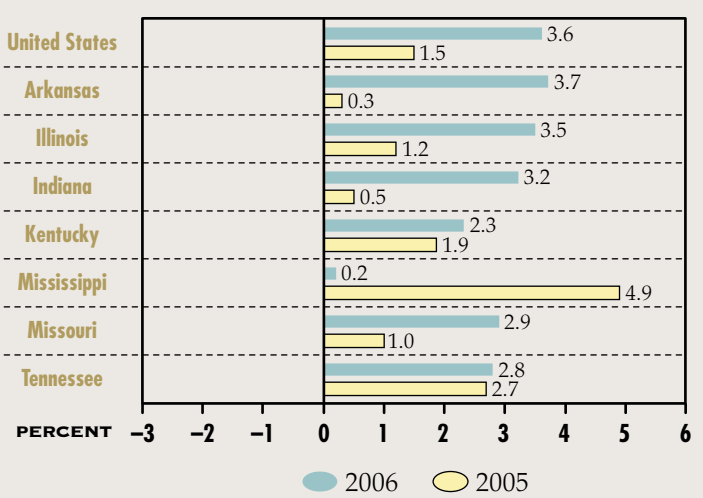
YEAR-OVER-YEAR PERCENT CHANGE IN YEAR-TO-DATE LEVELS



FOURTH QUARTER

Real Personal Income‡

YEAR-OVER-YEAR PERCENT CHANGE



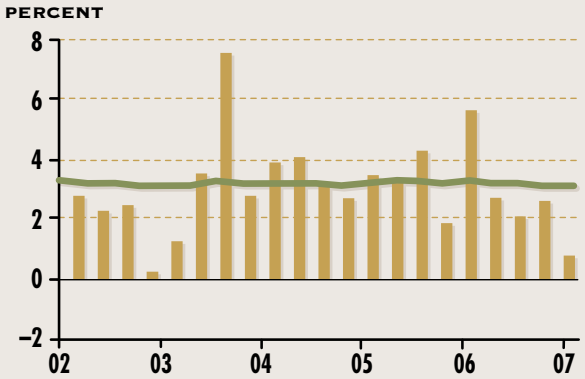
*NOTE: Data have been converted from the 1987 Standard Classification (SIC) system basis to a 2002 North American Industry Classification (NAICS) basis.

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

Major Macroeconomic Indicators

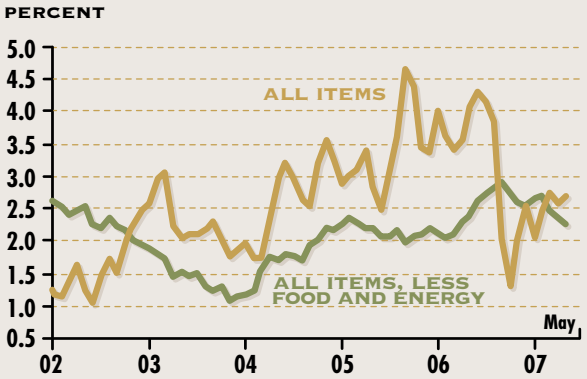
Additional charts can be found on the web version of *The Regional Economist*. Go to www.stlouisfed.org/publications/re/2007/c/pdf/07_07_data.pdf.

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

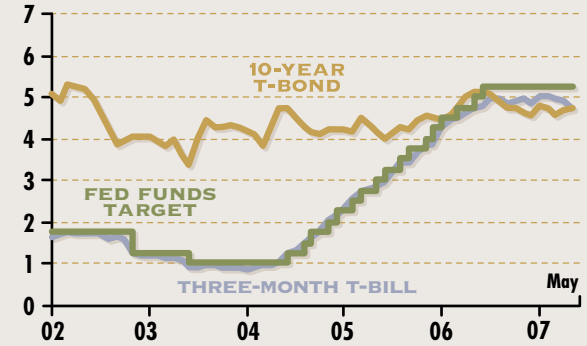


NOTE: Percent change from a year earlier

Civilian Unemployment Rate

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

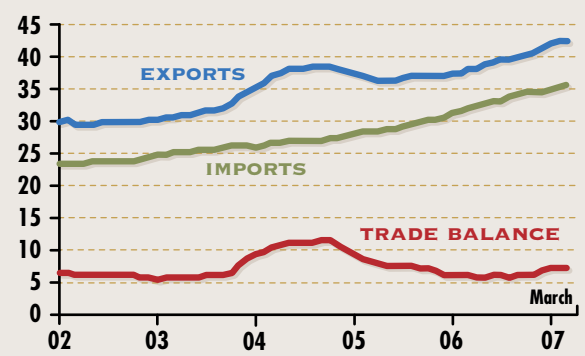
Interest Rates



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

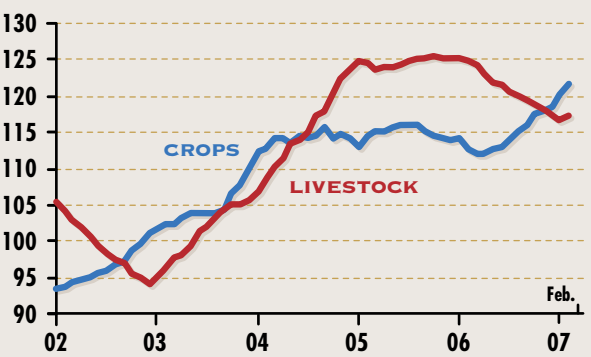
Farm Sector Indicators

U.S. Agricultural Trade



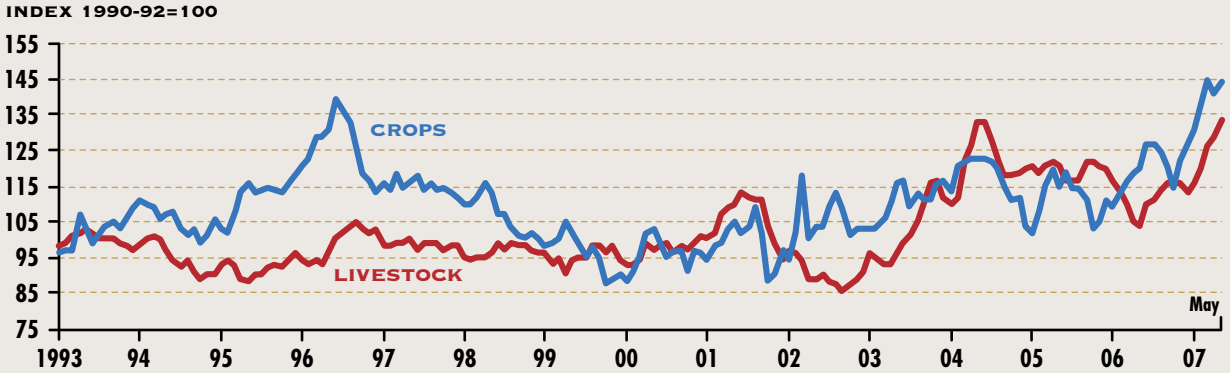
NOTE: Data are aggregated over the past 12 months.

Farming Cash Receipts



NOTE: Data are aggregated over the past 12 months.

U.S. Crop and Livestock Prices



2008 Will Bring Changes to *The Regional Economist*

Dear Readers,

Last year, we surveyed you to find out what you like and dislike about *The Regional Economist*. We also solicited your suggestions for making this publication better.

At long last, we're ready to share the results of this survey and to let you know what changes we are planning at your suggestion.

The changes will debut with our January 2008 issue—the 15th anniversary of this publication. Although we are still mulling over what should go into the "new and improved" *RE*, we're quite certain that you will see one additional article by our economists in each issue, as well as a new section that will give you a forum for your comments and questions. This section will also include results from our online polls and announcements of special programs involving our economists that are open to the public. In all of our articles, you may see a bit more zing, as our writers anticipate conflicting viewpoints and address those. They will also embrace well-reasoned debate and seek out more-timely angles—without rehashing what appears in the popular press.

Changes in the "look" of *RE* are also in the works. We'll switch to a more-traditional size—8.5 X 11, something many of you have requested to make filing easier. As we add pages, we will have space for more charts, photos and other artwork. The goal is to create a publication that you and others will want to spend more time with—and to increase everyone's understanding of major economic issues of the day.

These are not dramatic changes. But you didn't want such. In fact, many who responded to our survey asked us not to change a thing. On average, you gave *The Regional Economist* a score of 4.35 on a scale of 1 to 5, with 5 being the highest. You told us your favorite articles were those on monetary policy, on national public policy issues (such as Social Security, health insurance and the minimum wage) and on national economic benchmarks (GDP, CPI, etc.). You expressed a strong interest in articles in which multiple sides of an issue are argued, and you gave us hundreds of ideas for new issues to write about, everything from the overuse of credit to privatization to the underground economy.

The number of you who filled out our lengthy survey was flattering—more than 1,700 of our 12,000 subscribers. Here's some basic demographic info on *RE* readers: We're middle-aged, with almost 60 percent of us being between 41 and 65. We're well-educated: 39 percent have a master's degree and 28 percent have a doctorate. We work in a wide variety of fields: 23 percent in teaching or academic research, 16 percent in corporations, 15 percent in other financial services, 12 percent in banking. While our target audience is largely business executives, 45 percent of those who took the survey have some kind of degree in economics and 23 percent currently work as economists. Although we have "regional" in our name, only 32 percent of us live or work in the Eighth Federal Reserve District—our region. Surveys were returned not only from almost every U.S. state but from more than 20 countries.

One surprise was the lukewarm response to our ideas to expand our online presence. Relatively few of you said you'd read blogs, listen to podcasts or tune in to online chats with our economists. In fact, fewer than 40 of you took the survey online, even though we had it posted on our web site for months. Nonetheless, we are going to continue to offer more *RE*-related content online: audio interviews with economists; reader polls; charts, photos and articles to supplement what you get in the version of *RE* we mail to you each quarter. We think that, despite a slow start, our Internet presence is destined to become more popular. But don't worry—we have no plans to get rid of the printed version of *RE*.

For details on the survey results and to check out *RE*'s presence online, go to www.stlouisfed.org/publications/*RE*.

Thank you for reading this—and for reading *RE*.

Michael R. Pakko and Howard J. Wall, Co-editors

The Eighth Federal Reserve District

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

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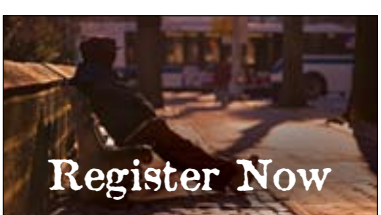

Trends in Neighborhood Unemployment

A presentation by St. Louis Fed economist Christopher Wheeler.
8-10:30 a.m., July 24,
at the University of Missouri-St. Louis.
See www.stlouisfed.org/community or call 314-444-8761.