

WINTER 2006

REGION FOCUS

THE FEDERAL RESERVE BANK OF RICHMOND

URBAN Poverty

One Family's Story

REGION FOCUS

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VOLUME 10
NUMBER 1
WINTER 2006

Our mission is to provide authoritative information and analysis about the Fifth Federal Reserve District economy and the Federal Reserve System. The Fifth District consists of the District of Columbia, Maryland, North Carolina, South Carolina, Virginia, and most of West Virginia. The material appearing in *Region Focus* is collected and developed by the Research Department of the Federal Reserve Bank of Richmond.

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Published quarterly by the Federal Reserve Bank of Richmond
P.O. Box 27622
Richmond, VA 23261
www.richmondfed.org

Subscriptions and additional copies: Available free of charge by calling the Public Affairs Division at (804) 697-8109.

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ISSN 1093-1767

Rules, Discretion, and the Future of the Fed



This issue of *Region Focus* appears as the Federal Reserve System welcomes a new chairman. On February 1, Ben Bernanke became only the 14th person to hold that position in the institution's 92-year history. The transition presents an opportunity to look back on the notable success that the Fed has enjoyed under outgoing Chairman Alan Greenspan, and to think about

the future of monetary policy.

The Fed's effectiveness in securing price stability over the past 25 years has been unmistakable. Greenspan's predecessor, Paul Volcker, took a series of bold steps to bring down inflation from double-digit levels. And since the late 1980s, early in Greenspan's tenure, inflation, as measured by the Consumer Price Index, has dropped from an average of more than 4.5 percent to about 2.5 percent in recent years. Just as important, inflation expectations also have become more stable. Keeping inflation contained over these last two decades is a remarkable accomplishment. And this low inflation did not come at the cost of real economic growth. During this period, the U.S. economy experienced the longest expansion since World War II, bookended by two brief, mild recessions.

Some observers have identified "flexibility" as the key to Fed policy under Greenspan. By this, they mean an approach to policy that is not excessively tied to any one doctrine. They contrast this trait with an approach to policy that follows a rigid rule — perhaps such as a numerical inflation target — and suggest that the success of the last 18 years demonstrates the virtues of discretionary rather than rules-based monetary policy. This distinction goes back 30 years to a paper which argued the opposite, that rules were better than discretion. That paper was written by Finn E. Kydland and Edward C. Prescott, who won the 2004 Nobel Prize for economics.

So does the success of apparently discretionary policy in the Greenspan era prove Kydland and Prescott wrong? No. It strikes me that those who see recent policy as evidence for discretion over rules are using the terms differently than originally intended.

The Kydland and Prescott analysis showed that a central bank taking a discretionary approach may be sometimes tempted to ease policy to boost employment and output, despite the risk of higher inflation. The anticipation that policymakers will behave this way in the future will drive up current inflation. The result is likely to be persistently high

and ever-rising inflation, with no substantial benefit for growth and employment.

To get around this problem, Kydland and Prescott said that policymakers would do better if they could "commit" to a pattern of behavior that avoids the temptation to ease policy at the expense of inflation. To work, this commitment has to be believable, or "credible." A rules-based policy involves any tool that allows the policymaker to credibly commit not to succumb to temptation. One way to achieve credibility is to adopt an inflation target. But this is not the only way. What is essential is a consistent pattern of behavior that the public understands and believes will dictate the central bank's future behavior.

So has the Greenspan Fed been discretionary or rules-based? The flexibility that many people emphasize points to discretion. But I think a careful examination suggests that Fed behavior in recent decades has been closer to what Kydland and Prescott would describe as adhering to rules. This is evident first and foremost in the clear and persistent articulation of a focus on price stability that has come through Greenspan's testimony before Congress and other official communications. Rule-like behavior is also apparent in the attention the Fed has paid to the public's expectations. Most notably, the Fed's move to greater transparency in the last 10 years or so has enabled it to craft Federal Open Market Committee statements that to some extent guide the public's expectations about future policy. This sort of attention to expectations can be every bit as constraining on policymakers as the announcement of and adherence to a narrowly defined rule for setting interest rates.

To my mind, building monetary policy credibility has been the true hallmark of the Federal Reserve under Greenspan's leadership. Maintaining such robust credibility will take continual vigilance. Key to this will be helping the public understand that we intend to respond to future conditions in a way that keeps inflation low and stable. Eventually, this may entail adopting a numerical inflation target or some other more formal, rules-based system. We have Greenspan's stewardship to thank for getting us to this point. Far from being "flexible," the Greenspan Fed gave up the flexibility to let inflation get out of control. Instead, it established credibility for our commitment to price stability.

JEFFREY M. LACKER
PRESIDENT
FEDERAL RESERVE BANK OF RICHMOND

William McChesney Martin, Jr.: A Reevaluation

BY JOHN H. WOOD

During his nearly 20 years as Chairman of the Fed, Martin helped to establish the institution's independence and to keep inflation relatively low, despite numerous pressures to follow a different course

It is high time that William McChesney Martin, Jr., is reevaluated. He was subjected to virtually unanimous adverse criticism from the economics profession during his tenure as the longest-serving Chairman of the Federal Reserve Board, from March 1951 to February 1970 (three months longer than Alan Greenspan). For instance, all 23 professors who appeared before Congress' hearings on "The Federal Reserve System after Fifty Years" supported Chairman Wright Patman's attack on the Fed's independence and the use made of it. Four, including Milton Friedman, favored money rules, and the rest joined Paul Samuelson in recommending the "coordination of monetary, fiscal, and debt policies" under the direction of the Executive.

This was before later monetary policies and inflations caused us to look back longingly at the record under Martin. Christina and David Romer have summarized monetary policy over "the past 50 years" as an "evolution from a crude but fundamentally sensible model of how the economy worked in the 1950s, to more formal but faulty models in the 1960s and 1970s, and finally to a

model that was both sensible and sophisticated in the 1980s and 1990s." Average annual inflation in Martin's first decade was 2.2 percent compared with 7.1 percent and 2.5 percent in the 1970s and 1990s. The first period was also the least volatile, with a 0.87 percent standard deviation of inflation compared with 1.60 percent and 0.93 percent in the later periods.

Robert Bremner's recent biography, *Chairman of the Fed: William McChesney Martin, Jr., and the Creation of the Modern American Financial System*, fills a gap in the history of central banking, and of the financial markets generally. This is not only because of Martin's importance to monetary policy through two eventful decades, but also because, as the first full-time president (at age 31) of the New York Stock Exchange (NYSE), he guided its accommodations with the New Deal regulators who wanted to remake the financial markets. What we see is a tough and consistent man. His principles were those of a conservator — of institutions and the value of money.

Martin's life is a story of battles for those principles even when, as was usual, he was in the minority and had to use his considerable negotiating skills. He can be viewed as the most determined fighter in the history of the Fed. Without downplaying the successes of Benjamin Strong, Paul Volcker, and Alan Greenspan, they benefited from government forbearance and considerable approval from the academic community. The last half of Martin's term, however, was a fight, with limited help from a divided Federal Reserve Board, against easy-money administrations supported by the majority of economists. He was known at once for his collegiality in



William McChesney Martin, Jr., was sworn in as Chairman of the Federal Reserve System by Chief Justice Fred Vinson on April 2, 1951. Thomas McCabe, Martin's predecessor, looked on.

PHOTOGRAPHY: AP WIDE WORLD PHOTOS

the Federal Reserve and his firmness (approaching obstinacy, President Lyndon Johnson thought) in dealing with threats from the outside, both of which contrasted with chairmen Marriner Eccles and Arthur Burns.

Martin was a conserver even in his efforts in 1951 on the side of the Fed's independence. The reestablishment of the independence that had been taken away in 1933 (although its subordination was most obvious in the bond support program — the “peg” — which began in 1942) places Martin in the pantheon of genuine central bankers. By this I mean those who focused on price stability instead of thinking of the Fed's actions as part of a coordinated fiscal and monetary program aimed at multiple goals. Martin's overriding objective at the Fed and NYSE was stability, cooperatively if possible, digging in his heels when necessary.

Our knowledge of his conflicts is mainly from others, with a few from Martin's accounts for the Fed's files. Evidence of his backbone was shown during a meeting of the “quadriad” (President Kennedy, Treasury Secretary Douglas Dillon, Chairman of the Council of Economic Advisers Walter Heller, and Martin), when the “exasperated” President asked Martin “why he would not agree with his other advisers” and “Martin responded that he was the only person in the room that did not work for the President.”

Martin's monetary policy was rooted in his background, and his actions at the Fed are better understood in light of his behavior at the NYSE in the 1930s and government service in the 1940s. The following discussion of Martin, the man, is taken largely from Bremner. The economic interpretations are mine. I hope the reader will agree that Martin's economic views were more sophisticated than he was given credit for.

Early Career

William McChesney Martin, Jr., was born in 1906. His father was appointed

Chairman of the Board of the Federal Reserve Bank of St. Louis in 1914, and served as president (called governor before the Banking Act of 1935) from 1929 to 1941. The St. Louis Fed district was predominantly rural, and in his teenage years, junior often

His principles were those of a conserver — of institutions and the value of money.

heard his father “expressing concern about excessive borrowing by overly optimistic farmers.” Farm values rose dramatically with farm prices during and after World War I, before they both collapsed in 1921. One-fifth of the banks in the district (and the country) failed in the 1920s.

Martin attended Yale, majored in English, and took some courses in economics, where, according to Bremner, he learned “that his father and other Federal Reserve bankers were considered hopelessly out of date because of their misguided warnings about excessive speculation in the stock market.” The foremost economist at Yale during this period was Irving Fisher, whose pronouncement a week before the Crash that stock prices had reached a “permanent high plateau” became famous. Martin's behavior three and four decades later demonstrates that he took the lesson. My job at the Fed, he would say, is to “take away the punch bowl just as the party gets going.”

After a brief stint as a bank examiner for the St. Louis Fed, Martin went to work for A.G. Edwards & Sons in November 1928, as a “board boy” who updated stock prices on a large chalkboard. His uncle, Albert Edwards, was managing director of one of the few significant securities firms away from the East Coast, which continues today with headquarters still in St. Louis. Martin soon became

the sole member of a new research department. During the next few years he witnessed the financial ruin of many of Edwards' clients.

In 1931, he moved to New York as Edwards' floor broker at the NYSE. He took courses in economics and finance at night school at the New School for Social Research, and was a leader in the organization of the *Economic Forum Quarterly*. The journal included articles by John Maynard Keynes and Josiah Stamp, and Martin continued as one of the publishers until they sold it in 1934.

Martin began to study for a Ph.D. in finance at Columbia but his attention turned to the governance of the Exchange. In May 1935, he was elected a governor. The Exchange had been under attack since the Crash and the new Securities and Exchange Commission (SEC) pressed for reforms. Change was resisted by many, including Richard Whitney, head of the Exchange, but a few sought accommodation. Martin was new and unsullied and found that “the out-of-town firms were glad to support me” as a member of the reform movement.

He would rise quickly to the top of the NYSE, where he would serve as president for three years. Much of his presidency was devoted to preserving the Exchange's position in the financial industry and the profits of its members. He was generous with promises of audits and stricter supervision, but there was no significant change in membership or trading practices, particularly in the dealer functions of the vilified specialists. Bremner writes of the failures of Martin's reform efforts but one could view his record more charitably, as resisting the call to make widespread, and perhaps hasty, changes.

Martin resigned his position at the Exchange in 1941, and entered the Army as a private. He rose to colonel as he spent the war working on Russian lend-lease, becoming

head of the program in 1945. Being a Missouri Democrat did not damage his postwar prospects, and in November 1945, John Snyder, St. Louis banker and adviser to President Truman, asked Martin to become president of the Export-Import Bank. Bremner describes Martin's term at Ex-Im as a succession of run-ins with the State and Treasury departments as he defended the institution's independence of politics.

On Jan. 1, 1949, Martin became assistant secretary of the Treasury for International Affairs under Snyder, who had become secretary in 1946. He was involved in the negotiation of currency realignments following the British devaluation in September 1949, and for the occupied former enemies. He became Snyder's confidant on a wide range of policy matters, and was drawn into the Treasury's dispute with the Federal Reserve.

The Fed was fighting for its independence from the Treasury — not for the first time. To put the dispute in historical perspective, the Federal Reserve Act of 1913 created a System of 12 district banks with general oversight by a Board in Washington whose members were appointed by the President of the United States (five members with rotating 10-year terms, changed to seven members for 14-year terms in 1935). The Federal Reserve banks were owned by their member banks, and their heads were chosen by their boards of directors. So the Fed was given considerable freedom from the Executive — if it chose to exercise it, which is not possible in wartime because it is duty-bound to support the war effort. That means the monetization of government deficits. The Treasury kept up its pressure on the Fed to prevent interest rates from rising after the end of World War I, a policy that caused the consumer price index to rise 31 percent between October 1918 and June 1920.

The Fed was relatively free from early 1920 until Franklin Roosevelt

became President in March 1933. Milton Friedman and Anna Schwartz have referred to the prosperous and stable-price 1920s as “the high tide of the Federal Reserve System.” The massive falls in money, prices, and employment during the Great Depression of 1929 to 1933 produced a reaction in which the Roosevelt administration assumed control of monetary policy.

The only significant changes in the Fed's structure were made by the Banking Act of 1935, under the influence of Mariner Eccles, a Utah businessman who was attracted to Washington by the New Deal, and became Chairman of the Federal Reserve Board in 1934. The most important change affecting policy in the long run was the formalization of the open market committee that had been a voluntary vehicle for coordination between Reserve banks. The new Federal Open Market Committee (FOMC) consisted of the seven governors of the Federal Reserve Board, the president of the Federal Reserve Bank of New York, and four more Bank presidents on a rotating basis. The Chairman of the Board also chaired the FOMC.

Structural changes were irrelevant while monetary policy was directed by the Treasury, which decided on a low-interest war, in particular, a Treasury bill rate pegged at 0.375 percent, and an average yield on U.S. long-term bonds of about 2.4 percent. The administration's pressure to maintain low rates persisted even longer than after World War I. The peg continued unchanged until July 1947, and bills had risen to only 1.14 percent at the cyclical peak in November 1948, despite average annual inflation of 10 percent from 1946 to 1948. The long bond yield was virtually unchanged at 2.44 percent.

Throughout this period the Federal Reserve tried to negotiate the freedom to fight inflation. It had occasional support from Congress but the administration would not abandon its low-interest policy. The Fed's resistance increased with the infla-

tionary pressures of the Korean War that began in June 1950, and it broke into open rebellion as President Truman's political position weakened. Martin represented the administration in negotiating the Treasury-Federal Reserve Accord that was announced on March 4, 1951:

The Treasury and the Federal Reserve System have reached full accord with respect to debt-management and monetary policies to be pursued in furthering their common purpose to assure the successful financing of the Government's requirements and, at the same time, to minimize monetization of the public debt.

Part of the agreement was Martin's appointment as Fed Chairman.

Chairman of the Fed

Although coming to the Fed from the Treasury, Martin, like Paul Volcker later, insisted on the independence of monetary policy. Martin's long tenure was filled with conflict but his positions in all of them redound to his credit when viewed from later perspectives of monetary theory and policy. The distinguishing features of his career are seen in four conflicts that extended over the five presidential administrations during which he served.

(1) Bills Only. The development of open market operations as the main instrument of monetary policy meant that the Fed had to be concerned with the performance of the government securities market. Standards had been set for securities dealers during World War II but the stability and liquidity of the market were unthreatened under the peg. One of Martin's first actions at the Fed was to chair an Ad Hoc Subcommittee “to study and report on the operations and functioning of the Open Market Committee in relation to the Government securities market” under the new free-market regime

of fluctuating yields. The subcommittee's objective was effective open market operations, which requires "an efficiently functioning Government securities market characterized by depth, breadth, and resiliency."

This was remarkably similar to the goals of the New York Stock Exchange, which regularly publishes "indicators of market performance" consisting of price continuity, market depth, and quotation spreads. Martin's quiet obstruction of the SEC attack on the integrity of stock trading was carried over to the promotion of similar performance in government securities. His purpose was to achieve flexibility in the determination of bank reserves without interfering with the efficient transfers of saving to investment. Therefore:

When intervention by the Federal Open Market Committee is necessary to carry out the System's monetary policies, the market is least likely to be seriously disturbed if the intervention takes the form of purchases or sales of very short-term Government securities.

Although the subcommittee's report correctly pointed out that "bills only," as the policy came to be called, was in "the best central banking traditions," it was received with hostility by economists for whom

monetary policy meant the readiness to force sudden and substantial changes in interest rates, especially long-term rates.

Outside the interventionist academic atmosphere of the 1950s and 1960s, though, Martin is more easily

The last nine years of Martin's term were a continuous battle with inflationary administrations.

defended. The prevailing IS-LM policy framework was a comparative-statics equilibrium model for given expectations. We have learned that short-term fiscal policies (such as the 1967 tax surcharge) which are known to be short term are ineffective. Ephemeral interest-rate policies may be even less effective. Whether the aim is reflation or disinflation, effective monetary policy requires the market's confidence in its seriousness. Martin's agreement is seen below.

(2) *Operation Twist*. The "bills only" policy was terminated in 1961 under pressure from President Kennedy's New Frontier program, which demanded no restrictions on policy instruments. The last nine years of Martin's term were a continuous battle with inflationary administrations. Kennedy's advisers were inclined toward fiscal policy but came up with a challenging program for the Fed

that aimed at the triple objectives of growth, balance of payments surplus, and price stability by twisting the yield curve. The Fed would stimulate long-term investment by buying long-term securities. At the same time, it would help the balance of payments by attracting short-term investments through the higher short-term yields that would result from sales of short-term securities. The program would not be inflationary because the added reserves from purchases of long-terms would be offset by the sales of short-terms.

The candidate had promised: "I have no doubt that any new Democratic President will find the Federal Reserve pursuing a somewhat different policy," and hinted that Martin might be replaced. After the election, when the chairman-designate of the President's Council of Economic Advisers Walter Heller called on Martin, the latter warned: "I'm not going to give up the independence of the Fed." But he added: "There's plenty of room for cooperation."

The administration persuaded Martin (despite dissents at the Fed) to nudge short-term rates upward while keeping long-term rates low. Operation Nudge turned into Operation Twist, which would involve vigorous actions to reduce long rates. "This is a historic reversal of policy," Heller wrote the

Martin served under these five presidents during his tenure as the Chairman of the Federal Reserve Board.

Harry S. Truman
(1951-1953)



Dwight D. Eisenhower
(1953-1961)



John F. Kennedy
(1961-1963)



Lyndon B. Johnson
(1963-1969)



Richard M. Nixon
(1969-1970)



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President, “for which Chairman Martin deserves our appreciation.”

Heller’s satisfaction was premature. Several members of the FOMC “were strongly opposed to the end of ‘bills only’ [as] a step back toward political interference in monetary policy and a pegged bond market,” wrote political scientist Donald Kettl, and Martin managed to obtain and keep the majority’s support for Operation Twist only by an execution that bordered on the imperceptible. The administration was disappointed with Martin’s “team spirit.” The trouble, Heller recalled, was that:

...we’d have a meeting with Kennedy ... and before the meeting Bill would be out there buying those long-term securities, but afterwards his buying would flag. ... [CEA member] Jim Tobin would keep track of this and he’d say, “Walter, you’d better ... arrange another meeting ... because Martin isn’t buying enough long-term bonds.” So I’d call a meeting and sure enough the purchases would rise again, and Martin would be able to tell Kennedy, “We’re doing everything we can.”

Kennedy’s advisers initially opposed the Fed Chairman’s reappointment in 1963, but backed away from that position when they discovered the level of support for Martin in the business community, both at home and abroad.

(3) *The Vietnam War and the “Credit Crunch” of 1966.* The Federal Reserve was expected to finance government spending, and presidents had demonstrated that they would make a political issue of price and interest increases. Martin wanted to address inflation by monetary restraint, but in addition to political threats, he had to deal with increasing opposition within the Federal Reserve as the “New Economists” came to the Board.

Martin tried to steer a course between the Keynesians and the

inflation hawks in such a way as to combat inflation without endangering the integrity of the Federal Reserve System. His difficulties were increased by the absence of any real discussion, or even understanding, with the Johnson administration. When Martin publicly warned that inflation might call for monetary restraint, Johnson’s Chairman of the Council of Economic Advisers Gardner Ackley told the President: “I don’t think we’ll ever have a Chairman of the Federal Reserve who is so completely out of the mainstream of economics.” Ackley’s own 1959 paper on inflation had ignored money and “argued that the inflationary process is essentially an administrative one. It arises from a largely autonomous upward pressure on wage rates relative to the cost of living, interacting with administered-price markups applied to rising wage costs ... in endless chain.”

The Board consisted of Martin, three Kennedy-Johnson appointees (George Mitchell and Dewey Daane, business economists from Federal Reserve banks, and academic economist Sherman Maisel), government lawyer James Robertson, appointed by Truman, and Canby Balderston and Charles Shepardson, college deans appointed by Eisenhower. The Vice Chairman of the FOMC was New York Fed President Alfred Hayes. Hayes, Balderston, and Shepardson were anti-inflationists who were usually joined by two of the rotating Bank presidents, while Robertson, Mitchell, Maisel, and two other presidents generally favored an easy-money approach aimed at keeping employment robust.

This five-to-five split left the deciding votes to Martin and Daane, who also leaned toward a policy of price stability. So, Maisel later wrote, decisions “generally favored the more restrictive targets. However, because a strong minority stressed broader objectives, as did the administration, moves to restrict credit were less frequent and more moder-

ate; those in the middle had to be sure of themselves before they joined the restrictivists.”

It was in this atmosphere that Martin urged the administration to ask Congress for a tax increase. When promises to do so were not kept, Martin obtained a commitment to act from a narrow majority of the Board. With his penchant for personalizing disagreements, Johnson announced to Martin: “I’m scheduled to go into the hospital tomorrow for a gall bladder operation. You wouldn’t raise the discount rate while I’m in the hospital, would you?” Martin paused, and in a reply that became legendary at the Fed, said: “No, Mr. President, we’ll wait until you get out of the hospital.”

Treasury Secretary Henry Fowler’s recommendation that Martin be replaced by Volcker (at the time, deputy undersecretary of the Treasury for monetary affairs) was not pursued, and on Dec. 6, 1965, the discount rate was raised. Johnson was enraged but the Fed kept up the pressure. Free reserves at member banks turned negative, and the Treasury bill rate rose from 4 percent to 5.5 percent. But inflation was not touched. In fact, the CPI rose 3.8 percent (at an annual rate) during the first six months of 1966 compared with 1.9 percent in 1965. Federal spending and the deficit continued to rise. However, the policy of restraint was ended by a “credit crunch” at the end of August.

Rising deposit rates threatened the solvency of institutions making long-term loans. In addition, banks and S&Ls lost time deposits because market rates rose above the legal maxima on deposit rates. The Fed gave way and resumed purchases. Martin resolved that next time they would stay the course.

(4) *Richard Nixon.* Though he campaigned on a largely conservative platform, President Nixon recoiled from the political costs of ending the inflation that he inherited. He did not trust Martin, whom he blamed for the recession that had cost him

the 1960 election, and wanted Arthur Burns at the Fed. However, Martin told the President that he would not step down before the end of his term on Jan. 31, 1970. In 1963, Martin had to be persuaded by Kennedy to accept reappointment and three times he offered his resignation to Johnson. Why the difference? Nixon did not seem likely to pursue more inflationary policies than his Democratic predecessors. That may be the answer. Kennedy and Johnson felt they needed Martin as a symbol of sound money and Martin knew it, whereas in addition to his personal animosity the Republican President did not feel the same need for a sound-money stamp.

Nixon's Council Chairman Paul McCracken hoped that inflation could be slowed without unemployment by a policy of "gradualism," when what was needed was just the opposite: to convince the markets that something significant was going to happen. Martin and the majority of his colleagues had stronger medicine than the Council's in mind. Worried about the administration's commitment and market expectations, they had raised the discount rate in December 1968, before Nixon took office. In February 1969,

Martin apologized to the Joint Economic Committee for past errors and said they would not be repeated:

It appears that the Federal Reserve was overly optimistic in anticipating immediate benefits from fiscal restraint ... but now we mean business in stopping inflation. ... A credibility gap exists in the business and financial community as to whether the Federal Reserve will push restraint hard enough to check inflation. The Board means to do so and is unanimous on that point.

He addressed the apparent lack of resolve on the part of the government, which "has raised the ghost of overkill at the first sign of a cloud on the horizon." *The New York Times* reported: "Martin strongly implied that this will not happen again and that restraint will persist even when there are clear signs the economy is slowing and in the face of some increase in unemployment."

The rate of money growth fell and unemployment rose, but inflation remained above 6 percent and the Fed raised the discount rate to 6 percent in April. The Fed kept its nerve until February 1970, when in Burns' first meeting, monetary policy

changed direction. The rest, as they say, is history.

Conclusion

Martin voiced the same sense of failure in 1970 as in 1941. He had left the Fed at a time when inflation was on the rise, as he had left the NYSE without instituting major reforms. In his defense, however, he fought inflation as hard and as successfully as anyone could have done, and he preserved the Fed as he preserved the NYSE. Bremner may be right when he says that Martin's greatest contribution was the strengthening of the Fed as an independent monetary authority, although that independence still must be seized.

Skeptical of staff analyses and forecasts, he never saw any redeeming qualities in inflation. His statements did not meet the explicit standards of modern monetary theory, but the positions to which they referred were consistent with what is now thought to be the best in theory and policy. This includes his anticipations of later moves toward the transparency of the Fed's intentions and the willingness to take preemptive actions. **RF**

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BEYOND PLASTIC

Capital One Sticks with Plan to Buy Hibernia

On Nov. 14, 2005, Capital One Financial Corp. became the 19th-largest bank in the nation. The McLean, Va., company, known for its credit card and consumer lending business, had announced in March that it would pay \$5.35 billion for Hibernia Corp. The news was not a total shock. Capital One had previously said it was interested in buying a bank for several strategic reasons.

The whole deal looked shaky on the scheduled closing date, however. It was Sept. 1, just days after Hurricane Katrina ripped through the Gulf Coast and flooded New Orleans, Hibernia's headquarters city. The parties immediately pushed back closing a week, and announced a renegotiated sale price of about \$5 billion with closing set for November. Under terms of the deal, Hibernia becomes a Capital One subsidiary and gives up its name.

In a Sept. 20 conference with investors, Capital One's Chief Financial Officer Gary Perlin said that of Hibernia's more than 300 branches, 21 suffered significant damage, but that most are expected to reopen. As the largest bank in Louisiana, Hibernia is expected to play a lead role in the reconstruction effort, serving as a conduit for federal and insurance funds that flow into the region. "We've been working very closely with Hibernia to take advantage of those opportunities," Perlin said.

As for Capital One's overarching plan, Perlin said: "It's very much in line with Capital One's strategy of building and maintaining leadership positions in a number of national-scale lending businesses in the consumer space. Hibernia adds to that a local scale deposit business in Louisiana as well as growth opportunities they have demonstrated they can take advantage of in Texas."

Other advantages of getting into retail banking include the ability to sell credit cards to banking customers, who tend to be better credit risks than people without bank

accounts. It's also a clear-cut survival strategy in a time when pure-play, or mono-line, credit card firms are disappearing and big banks are concentrating on the credit card business.

"The mono-lines are going out of business," says Tony Plath, a finance professor at the University of North Carolina at Charlotte. "Their operating income cycle tends to be more volatile because their business line is concentrated in just one or two businesses. They're also vulnerable because they can only grow their business in one way."

— DOUG CAMPBELL



Capital One completed its foray into retail banking in November with the purchase of New Orleans-based Hibernia.

A "DRIVER'S LICENSE" FOR WORKERS?

Virginia Leads in Issuing Employability Certificates

Matching skill supply with demand in labor markets can be tricky. Work force development and education officials in the Fifth District hope to bridge the information gap with "employability" certificates. This portable credential aims to reduce friction in labor markets.

Virginia has awarded more than 5,000 certificates since 2004. With the backing of the Virginia Manufacturers Association and other business groups, companies such as Northrop Grumman Newport News have used the certificate during the hiring process.

Virginia's Career Readiness Certificate (CRC) is designed to ensure that the recipient meets

certain standards in reading, applied mathematics, and information retrieval. Those three skills meet the basic requirements of 85 percent of jobs, according to the non-profit ACT Inc., a testing firm. The certificate includes an exam score and a description of its meaning. Exams are administered at 44 local work force development centers and at the state's 23 community colleges.

Workers armed with a CRC have information on their employability that is widely understood and accepted. That can give them greater geographic freedom in the job search. On the flip side, an employer with operations in different locations could use the same CRC to evaluate workers.

Three Baltimore Schools Improve Test Scores

Companies have long relied on some sort of credential to signal whether an applicant has the minimum skills for a job. This credential has usually been a high school diploma, but that may not be good enough for some jobs anymore.

“More and more jobs require some postsecondary training,” says Jon Erickson, vice president of educational services for ACT Inc. “At the same time, high schools have had a glut of students, teacher shortages, and a whole bunch of curriculum issues.” His company’s skill assessments are being used to develop a certificate equivalent to Virginia’s CRC in the District of Columbia, Maryland, West Virginia, the Carolinas, and other states.

“Employers have gotten frustrated because credentials don’t guarantee that people have the skills they want,” adds Sondra Stein. She is program manager for a Work Readiness Credential under development at Equipped for the Future, an initiative funded by the National Institute of Literacy, several trade and nonprofit organizations, and governments in five states and the District of Columbia. (D.C. is involved in the development of two different employability certificates.)

Stein says that public schools devote more time to developing core academic skills at the expense of “soft” skills like communication and cooperation that are highly valued in the workplace. At the same time, employers have raised the bar for what they need in a worker.

That’s why some firms look for employees with an associate degree from a community college or a professional certification. But even this information may be inadequate.

While working as chief economist at the State Council of Higher Education for Virginia, Fletcher Mangum held focus groups to find out more about the intersection of education and economics. “One of the things we commonly heard from business owners was that a degree didn’t really tell them what skills a person had,” says Mangum, now a Richmond-based consultant. He worked on the taskforce that developed Virginia’s CRC. “A degree was too generic and the quality of the information it conveyed about the person’s skill sets and educational level varied from institution to institution.”

Mangum says it’s more efficient for government to administer a single statewide assessment rather than use many tests individually provided by employers. “Employability certificates remove a lot of uncertainty from the [hiring] process,” he notes. Skeptics of the approach, though, note that a decentralized certification system has served many companies well, and are reluctant to see any single system crowd out competitors. — CHARLES GERENA

Edison Schools in the Fifth District

	Elem.	Middle	High
Allendale, SC	2	1	1
Baltimore, MD	3	0	0
Charleston, SC	5	2	1
Washington, D.C.	2	1	1
TOTAL	12	4	3

SOURCE: Edison Schools Web site

Three Baltimore public schools under for-profit management since 2000 have made progress, according to federal academic standards. And two of the three schools have made it off Maryland’s “needs improvement” list.

From the beginning, the decision to pay the private firm, Edison Schools, to manage three failing inner city elementary schools was controversial.

“When they first came in, everyone was in an uproar because someone was taking over their neighborhood school,” says Zelda Holcomb, Edison’s operations vice president and general manager for the Baltimore region.

Edison’s contract has been renewed through 2007. The

state pays the firm and then subtracts the total cost for running the three schools from the city school system’s funds. In the 2003-2004 school year, the most recent for which data is available, Edison received \$8,880 per pupil to operate three Baltimore schools, according to Mary Clapsaddle of the Maryland State Department of Education’s accounting office. Money for Edison employees’ retirement comes from the city school system. Edison is the

nation’s biggest for-profit manager of public schools, with 136 schools in 19 states and the District of Columbia in 2005-2006. The firm earned an after-tax profit of \$700,000 on revenues of \$411 million for the fiscal year ending June 30, 2005. It was the first profitable year for Edison, which opened its first four schools in 1995.

Jim Foran of the Maryland State Department of Education likes Edison’s work. “The professional development, community involvement, the inviting environment when you go into one of these schools — it looks very different than when you go into one of these [other] urban schools,” Foran says.

All three of the schools made “adequate yearly progress,” a benchmark established by the federal government. Before Edison assumed management, the three public schools in question were among the worst in the city. “AYP [adequate yearly progress] is a measure the federal government established for schools showing sufficient progress not to be put into an improvement activity,” he says. “It’s an assurance to parents that schools are operating well, academics are serious, and children on average perform well enough on that benchmark.”

Edison Schools aims to raise achievement through

curriculum changes, technology, professional development, and parental involvement. Holcomb says the Edison model works. “These are the research-based techniques for professional development, the structure of the school, and behavior management,” she says. “It’s data-driven accountability.”

For example, the schools have encouraged various adult groups to help out. A group of volunteers, calling themselves the Mighty Men of Montebello, works with Montebello Elementary School, a school of nearly 1,000 students, 84 percent of whom receive a free or reduced-price school lunch, an indicator of poverty. A grandparents’ club also has been formed at that school. “We have some people on the board at Furman-Templeton [another Edison school] from the local church,” Holcomb adds.

The contract will automatically terminate in 2007 because the federal No Child Left Behind Act supersedes the state legislation under which the state assumed control of the failing schools. Foran says that even though the state no longer has the ability to take over individual schools under the act, the city could become a partner with Edison Schools or form charter schools, deregulated public schools that are designed to deliver on goals stated in the charter.

It is difficult to compare achievement results in Edison Schools with other schools. A RAND Corporation research brief, commissioned by Edison, examined Edison schools and reports: “Edison results relative to comparison schools improve in years four and five, but whether those improvements ultimately yield net positive effects is the key question.” — BETTY JOYCE NASH

NATIONAL FLOOD INSURANCE

Henderson County, N.C., Joins the Crowd

County officials in Henderson County, N.C., balked at joining the National Flood Insurance Program for years. They figured that by not passing a flood ordinance, one of the requirements for joining, they were doing the county’s heavily developed landscape a favor: People couldn’t get loans to build in flood areas without insurance and so they just wouldn’t build in risky places. (See “After the Flood” in the Winter 2004 issue of *Region Focus*.)

Wrong. Rocky Hyder, Henderson County’s coordinator of emergency management services, says that demand for property in the scenic mountain county had gotten so high that the cost didn’t discourage developers from filling in properties that were technically in flood-prone areas. And, on top of that, the county was ineligible for most types of federal disaster assistance after Hurricanes Ivan and Frances, which hit the county hard in 2004. So, after four months of controversy, Henderson County

commissioners finally passed the county’s flood ordinance in July 2005.

“Due to the current regulations both at state and federal level with regard to participation in the National Flood Insurance Program, and limitations implemented by state and federal government for disaster assistance funds, the staff felt like we had to adopt some type of flood damage prevention ordinance and participate at some level,” Hyder says. Two enforcement officers were added to the staff. The law prohibits development in the flood way, the most vulnerable land near rivers and streams. About 10 percent of the county’s land lies in a flood-prone area.

“It also prohibits most development in about 80 percent of the flood fringe, an area mapped on the flood insurance rate maps,” Hyder says. “The commissioners basically said if you had an existing lot at the time the ordinance was passed, then 20 percent of the lot in flood fringe could be modified, but no more than 20 percent, so as not to transfer flood storage to a neighbor.” When flood-prone areas are filled in one place, typically land elsewhere along the stream will be affected. After all, floodwater has to go somewhere.

The National Flood Insurance Program, under the Federal Emergency Management Agency (FEMA), allows homeowners to buy flood insurance from private insurers who are paid to administer the program. The U.S. Government Accountability Office has found that while FEMA has kept the program financially sound in general, the floods of 2004 and 2005 have required FEMA to borrow \$300 million, as of August 2005, from the U.S. Treasury to help pay an estimated \$1.8 billion in flood insurance claims. After Hurricane Katrina, Congress increased FEMA’s borrowing power from \$1.5 billion to \$3.5 billion. As of August 2005, the NFIP had about 4.6 million policyholders in about 20,000 communities. Since it began in 1968, the program has paid out about \$14.6 billion in claims, mostly through premiums.

The program, though, is not actuarially sound — about 29 percent of policies were subsidized, the GAO reported in 2003. “As a result of these subsidies, some policyholders pay premiums that represent about 35 percent to 40 percent of the true risk premium.” — BETTY JOYCE NASH

WINNING TICKET?

Lottery Coming to North Carolina

North Carolina is set this spring to become the 42nd state nationwide — and last in the Fifth District — to operate a lottery. State lawmakers last summer narrowly voted in favor of adopting a lottery, and Gov. Mike Easley signed the North Carolina State Lottery Act into law on Aug. 31. Tickets are tentatively set to go on sale April 5.

As is the case with many other state lotteries, proceeds from North Carolina’s are chiefly to go to education. The

state expects to reap \$425 million for educational purposes in fiscal 2006. Easley has been pushing for a lottery since 2001, arguing in part that the state was losing potential revenue to neighboring states with lotteries. His goal is to use the money to reduce classroom sizes. North Carolina's move into state-sponsored lottery follows South Carolina, which joined the ranks in 2002.

Lotteries in the United States generated total sales of \$48.8 billion in fiscal 2004, according to the North American Association of State & Provincial Lotteries, with "profits" — or the amount transferred to state coffers — of \$13.9 billion.

In adopting lotteries, states face controversial trade-offs. With the windfall of revenue come questions about propriety of depending on gambling to fund education. After all, the chance of winning many lotteries is worse than one in 135 million. Additionally, as argued by the nonprofit Tax Foundation, lawmakers can sometimes "shuffle other funds so that lottery tax revenue supplants, rather than supplements, existing funds for education."

Some economists describe lotteries as a de facto excise tax, in which the cost is borne by those paying for the product. This feeds the problem that a small percentage of players accounts for more than half of all lottery sales, and that those with household incomes of less than \$10,000 represent nearly 10 percent of the heaviest players. (See "The Revenue Game" from the Fall 2002 issue of *Region Focus*.)

Additionally, publicly run lotteries tend to have very high operating costs. So if you aren't opposed to them for normative reasons — that is, you think it's just wrong for the government to sanction this activity — then you still might want to consider having the state turn the operations over to a private firm. This would yield a higher share of "profits" to the state, even after the private firm takes its cut.

The regressive nature of lotteries is problematic in the sense that low-income households aren't just substituting expenditures on lottery tickets for other forms of gambling; they are spending less on necessities such as food and clothing. That's according to a recent study by Brookings Institution economist Melissa Schettini Kearney published in the *Journal of Public Economics*. Kearney concluded that the average household reduces consumption by \$41 a month in response to the introduction of a state lottery. This

Cashing In

About one-fourth of the U.S. lottery proceeds go to government coffers.

	Lottery Sales (mil.)	Profit (mil.)
DC	\$245	\$76
MD	\$1,395	\$458
SC	\$950	\$290
VA	\$1,262	\$408
WV	\$1,303	\$512
US	\$48,801	\$13,902

SOURCE: North American Association of State & Provincial Lotteries; Fiscal Year '04

finding also weakens the argument that states are losing revenue to neighbors who offer lotteries; most of their residents weren't gambling in the first place until the new lottery came along.

Lawmakers can mitigate the regressive nature of the lottery, Kearney says. Low-income lottery players tend to buy instant "scratch-off" tickets rather than the bigger jackpot "lotto" games. "If you want your state lottery to be less regressive, then you should focus on the bigger jackpot games or limit how many instant games you offer," Kearney says. — DOUG CAMPBELL

A DANVILLE TRADITION NO MORE?

Indian Firm Buys Dan River Inc.

Dan River Inc., based in Danville, Va., was sold in January to an Indian firm, GHCL Ltd. The price has not been officially disclosed, but Indian media and other sources place the number at about \$17.5 million, along with the assumption of about \$80 million in debt. Dan River emerged from Chapter 11 bankruptcy in February 2005.

The company, rooted in Danville since 1882, currently employs about 1,700 workers in the United States, including roughly 1,100 in the Danville region. Nearly 500 of those people will lose their jobs in March due to planned cuts in production near the company's headquarters.

The company has been shedding workers and facilities for some time. "It is not a new thing," says Calvin Barnhardt, vice president of human resources at Dan River. "We have, since 2002, closed probably 14 facilities." In early December 2005, for instance, the firm announced a plant closing in Morven, N.C.

The firm expects to remain a separate corporate entity to keep its brand names and licenses. "We certainly will be looking to capitalize on that very important asset and that's the name Dan River," says Barnhardt. "If the name Dan River all of a sudden went away, then you lose that continuity and you lose that establishment you have in the marketplace. We want to preserve that and use it as a springboard to offer a wider range of products."

North Carolina State University economist Michael Walden predicts that the decline in textiles jobs will continue. Those firms remaining in the United States will likely concentrate on niche production of "specialized textile outputs, where proximity to the U.S. market is important," Walden says.

The news of further textile consolidation comes on the heels of Vaughan Furniture Co.'s recent announcement to close one of its two factories in Galax, Va., about 100 miles west of Danville. The closing is due to cheaper Chinese imports, according to company officials, and will result in about 200 job losses. — BETTY JOYCE NASH

Endogenous

BY ERIC NIELSEN

At most stores, prices are not negotiable. If you want a new television, you pay the price the store is asking. But an economist might look at this situation differently. That's because the actual price of all consumer goods is partially determined by the purchasing decisions of consumers. In the economist's view, prices are not so fixed.

This is a classic case of distinguishing between factors that are either "endogenous" or "exogenous." The distinction is crucial to understanding the economy and economic models. Roughly speaking, exogenous quantities are those which are determined from the "outside." In the example above, prices are exogenous for the individual consumer, since one person's impact on the equilibrium market price is negligible. By contrast, prices are not exogenous for the entire market; they are determined by the interaction of supply and demand. Thus, for the economy as a whole an economist would say that prices are endogenously determined — that is, determined "from the inside."

In any useful economic model, the distinction between endogenous and exogenous must be clear. All models must have at least one exogenously determined element to prevent the model from becoming hopelessly circular and self-referential.

An economist wishing to create a model of consumer behavior might take prices, preferences, and budgetary constraints as "exogenous" inputs to determine which goods are purchased and in what quantities. Yet an economist wishing to model the overall market for a group of goods would not take prices as exogenous. He would construct a model in which exogenous factors in the overall economy, such as productivity, tax rates, and other determinants of supply interact with "endogenous" demand to yield a market price for the good. The challenge is to construct a model that accurately identifies factors as endogenous or exogenous. What is endogenous or exogenous may change depending on what question is being asked.

In real life it is not always so easy to divide everything into endogenous and exogenous categories. For instance, is it better to take government structure as exogenous to economic life, or to model government structure as emerging, along with the economy, from still more fundamental factors? Indeed, much economic debate centers on what one can reasonably take as exogenous. In many cases the "art" of economics is to find reasonable assumptions about exogenous factors that greatly simplify analysis.

When comparing the economic performance of nations, economists often look to the structure of government. Places with healthy economies tend to have well-defined property rights, advanced legal infrastructures, and democratic governance. Economists have labeled such factors "institutions," and a major area of research is finding ways of isolating the differential effects such institutions have on economic performance. But isolating these effects can be complicated. For instance, it's

possible that good economic performance leads to the development of good institutions (reverse causation) and that past institutions tend to affect present institutions.

One way out of this dilemma has been to use instrumented regression. The actual definition of instrumented regression is fairly technical, but the basic idea is simple: Find an exogenous condition that is correlated with the variable of interest — in this case, institutions — and uncorrelated with any other aspect of the economy. Then,

through the lens of the exogenous condition, one may examine the effects of institutions.

For example, in a series of papers on colonial development, economist Daron Acemoglu at the Massachusetts Institute of Technology has argued that, during the colonial era, disease conditions determined the type of institutions imperial powers established in their overseas possessions. Since it seems unlikely that disease conditions hundreds of years ago could have some other effect on current economic performance, one can attempt to ascertain the importance of institutions by examining historical disease rates.

"Many economists and social scientists believe that differences in institutions and state policies are at the root of large differences in income per capita across countries," write Acemoglu and two co-authors in a paper published in 2001. "There is little agreement, however, about what determines institutions and government attitudes towards economic progress, making it difficult to isolate exogenous sources of variation in institutions to estimate their effect on performance. [We argue] that differences in colonial experience could be a source of exogenous differences in institutions."

At their core, many economic debates focus on whether to call a variable exogenous or endogenous. Does democracy promote economic growth? Does capital punishment deter crime? The most reliable answers come from models in which economists have properly decided what to put in — or leave out. **RF**



ILLUSTRATION: TIMOTHY COOK

Should We Worry about the Current Account Deficit?

BY AARON STEELMAN

By most standards, the American economy looks pretty strong. Gross domestic product (GDP) increased roughly 3.5 percent in 2005, the unemployment rate fell to about 5 percent, and inflation remained relatively tame.

Still, some worry that those good data mask a more important truth — that the United States is becoming a heavily indebted nation. These skeptics point to the growing current account deficit, which measures the gap between what Americans earn and spend abroad. For 2005, the current account deficit was roughly 6 percent of GDP. Total net foreign liabilities now amount to roughly 25 percent of GDP. These figures are large by historical standards. But are they necessarily bad? Should we worry about America's growing current account deficit?

In a recent paper in *Foreign Affairs*, David Levey, formerly the managing director of Moody's Sovereign Ratings Service, and Stuart Brown, an economist at Syracuse University, argue that America's foreign debt poses little threat to the United States. Indeed, they claim that the current account deficit is increasing largely because of the strength of the U.S. economy.

Let's consider why we might be concerned about America's foreign debt. By definition, a large current account deficit means that foreign investors and governments are holding substantial dollar-denominated assets. Should a few big holders of these assets decide that they are no longer desirable and sell them, it's possible that this could set off a panic, resulting in a plummeting dollar, rising interest rates, and a shrinking U.S. economy. The net effect could be a global recession. This scenario is similar to what happened in Mexico and Thailand in the 1990s. But if it were to occur in the United States, the effects would be much more significant because the American economy is so much larger.

Levey and Brown argue that the current account deficit can be explained in terms of three different factors: trade, domestic savings and investment, or the composition of global wealth. "In each case, though, the risks are far less dire than they are made out to be," they argue. "And in many ways, chronic current account deficits reflect strong economic fundamentals rather than fatal structural flaws."

Consider a trade-based account, the central part of which is the relative strength of the U.S. economy. "In this view, the United States has a stubborn current account deficit because it grows faster than its trading partners and spends a dispro-

portionate share of its growing income on imported goods and services," Levey and Brown write.

Under the second scenario, the current account deficit results from the difference between total investment in the United States and domestic savings. But Levey and Brown argue that neither savings nor investment is well measured. "Capital gains on equities, 401(k) plans, and home values are excluded from measurements of personal savings; when they are added, total U.S. domestic savings is around 20 percent of GDP — about the same rate as in other developed countries," they write. (Of course, if home prices decline, as many analysts predict, this would weaken the case made by Levey and Brown.) On the investment side, "intangible" investments, such as on-the-job training and new-product development, are not included in the national account, even though they are large and growing.

The third approach focuses on international capital movements. Levey and Brown predict that, as the U.S. economy continues to grow, it will become an increasingly attractive place for foreign investment from China, India, and other developing countries. This could generate high current account deficits, but the reasons would hardly be cause for concern.

In a response to Levey and Brown that appeared in a subsequent issue of *Foreign Affairs*, economists Brad Setser of Oxford University and Nouriel Roubini of New York University take a much less sanguine view. They argue that foreign central banks — mostly in Asia — are not buying dollar-denominated assets because of strong conditions in the United States. Rather, they are doing so to keep the U.S. economy afloat — but that will eventually prove too costly and come to an end. "Celebrating the United States' real economic strengths while ignoring the real — and growing — economic vulnerabilities associated with unprecedented current account deficits is dangerous," write Setser and Roubini.

Ultimately, it's not clear how big of a risk the current account deficit poses to the U.S. economy. On this issue, there is no consensus among economists. So what should the U.S. central bank — the Fed — do in the meantime? Continue to focus on its core mission: maintaining price stability. If there's a relatively sure way to induce foreign investors to shed dollars and dollar-denominated assets, it's to engage in inflation. **RF**

"The Overstretch Myth"

by David H. Levey and Stuart S. Brown.

Foreign Affairs, March/April 2005,

vol. 84, no. 2, pp. 2-7.

Federal Terrorism Insurance Program Renewed

BY JOHN R. WALTER

On Dec. 22, 2005, President Bush signed legislation renewing the Terrorism Risk Insurance Act of 2002 (TRIA), which otherwise would have expired Dec. 31. TRIA was enacted, as a temporary measure, in response to the attacks of Sept. 11, 2001. It was intended to ensure the availability of insurance covering businesses' losses resulting from any future terrorist attack. The renewal lasts until 2007.

Following the Sept. 11 attacks, the price of terrorism coverage rose. The media carried stories of lenders withdrawing support from commercial construction projects because of these projects' inability to acquire terrorism coverage at a feasible price. Observers were fearful of possible macroeconomic effects if construction declined, especially in a then recession-weakened business environment.

TRIA promised that the federal government would reimburse property and casualty insurance companies for most of the claims they paid, above a specified amount, due to any future terrorist attack. It also required all commercial property and casualty insurers to offer terrorism coverage to their customers.

According to the text of the law, its purpose is to "ensure the continued widespread availability and affordability of property and casualty insurance for terrorism risk; and allow for a transitional period for the private markets to stabilize ... and build capacity to absorb any future losses..." By these measures, the law appears to have been successful. According to a recent study by the Department of Treasury, the number of businesses with terrorism coverage increased, and prices declined, after TRIA was implemented.

The federal government provides reimbursement to firms if the following two conditions are met: First, the terrorist attack must produce at least, in aggregate, \$50 million in 2006 and \$100 million in 2007 in insured losses. Second, before the Treasury provides any reimbursement the insurer must have met a deductible which it pays out of its own funds. Once the deductible is met the Treasury reimburses the insurer for 90 percent in 2006 and 85 percent in 2007 of its terrorist claims. The percentage deductible increased from 1 percent of all premiums collected by an insurance company, immediately following the law's enactment to 17.5 percent in the program's fourth year, 2006, and 20 percent in 2007.

At base, TRIA provides public backing for the liabilities of private insurance companies, helping insurers to meet their obligations to their policyholders. Such government backing is not unusual. For example, the Federal Deposit Insurance Act of 1933 established the FDIC to back deposits held in banks. What is unusual about TRIA is that it offers this backing free of charge, unlike the FDIC which charges premiums.

Since there are no charges associated with TRIA protection, the program provides a subsidy to insurers — and if the commercial insurance market is competitive, to policyholders as well. When the government provides a subsidy, economists worry that too much of the subsidized good will be produced. Given the subsidy of terrorism insurance, companies may take less account of the danger of terrorist attack than they should when making important business decisions. Too many buildings may be built in risky locations, and too little effort may be devoted to building structures that would withstand an attack, or to investing in security efforts. When all such decisions are combined, the final effect could be greater exposure to losses due to terrorist attack than would be the case without the subsidy.

The government could limit these distortions by charging risk-adjusted premiums for the insurance coverage it provides. (It's worth noting that this would not solve the problem entirely. Even if it were priced, government-provided terrorism insurance would likely produce some market distortions.) The FDIC, for instance, charges higher premiums to banks judged more likely to fail. By doing so, the subsidy is reduced.

Why does TRIA not include a provision for risk-adjusted premiums? While the legislative history of the law is unclear on this point, there are several possible reasons. For instance, determining the risk could be quite difficult — perhaps more difficult than determining the risk of bank failure. How much more subject to terrorist attack is a building in New York than one in Atlanta, or in Peoria? No one knows the answer for sure, but a risk-adjusted premium must account for such differences.

Still, most analysts think that terrorist attacks are more likely to take place in large cities than in small ones. This has important implications. Economists have argued that there exist large economic benefits to bringing workers together in a concentrated area. But given that terrorist attacks are more likely in large cities, people have reason to avoid these locations. This could impose significant social costs. If TRIA makes locating in large cities more desirable, some of those costs could be offset.

On balance, then, the effects of the federal terrorism insurance program are unclear. It almost surely has distorted some firms' decisionmaking about construction and security. At the same time, it may have kept some firms from fleeing major metropolitan areas, despite the advantages of being in those cities. A fuller examination of its costs and benefits awaits.

RF

John R. Walter is a research economist at the Federal Reserve Bank of Richmond.

Another Reason to Keep Inflation in Check

BY DOUG CAMPBELL

“Avoiding the Inflation Tax.” Huberto M. Ennis, Federal Reserve Bank of Richmond Working Paper No. 05-10, October 2005.

Even people who don't pay much attention to the workings of the Federal Reserve System have a vague awareness that part of the institution's job is to stabilize prices. High rates of inflation, it is largely taken for granted, spell problems for the economy. But why precisely is that so?

One of the chief reasons is thought to be the so-called “inflation tax.” In times of fast-rising prices, money loses value — a dollar at some time in the future probably will buy less of the same good than it does today. In this environment, consumers begin to expect that prices will continue to rise. A rich economic literature, pioneered by the early neoclassical economist Irving Fisher, posits that consumers may be in a hurry to avoid what they presume will be even higher prices in the near future.

Pinning down this intuition in a more formal manner has been elusive, however. Economists have been largely unable to build mathematical models that demonstrate the potential harm caused by the inflation tax. In fact, many models suggest that the welfare costs of high inflation are relatively small.

In a recent article, Richmond Fed economist Huberto Ennis sets out to directly test Fisher's hunch that the inflation tax incites people to spend their money with undue haste. His model differs from previous ones in that he tries to align the interest of buyers and sellers to more accurately reflect inflationary pressures on both of them.

What Ennis found is that consumers settle for lower-quality goods, particularly for goods they buy infrequently. Rushed, consumers have no patience for distinguishing between high-quality or low-quality goods — it is too costly to spend much time searching for the best product in an environment where money is losing value.

Such behavior could make the economy less efficient, Ennis says. If people are willing to buy goods without spending the usual amount of effort finding the best quality, then producers may anticipate that they no longer need to produce goods of decent quality. “Inflation distorts in many important ways the pattern of transactions of individuals in a monetary economy,” Ennis writes. Ennis' model doesn't look at the producer side of the equation, but his findings on buyers' behavior suggests it's worth a look.

“Changes in the Federal Reserve's Inflation Target: Causes and Consequences.” Peter N. Ireland, Federal Reserve Bank of Boston Working Paper No. 05-13, August 2005.

With the change in leadership of the Federal Reserve System, economists have been weighing in on the relative merits of a rules-based or discretionary-based monetary policy. The rules-based school of thought favors an explicit inflation target. The discretionary school prefers more of an implicit target of between 2 percent and 2.5 percent, much as the Fed operated under the leadership of outgoing Chairman Alan Greenspan.

Peter Ireland, an economist at Boston College and a consultant to the Boston Fed, created a model that aims to determine the Fed's implicit inflation target from 1959 forward. What's striking is the wide variability. Ireland found that the implicit target bounced around a lot, from about 1.25 percent in 1959 to more than 8 percent in 1974 and 1980. Without these target changes, Ireland says, inflation never would have topped 4.5 percent. By attributing most of the rise and fall in inflation to Fed policy, “the results confirm that to a large extent indeed, postwar U.S. inflation is a ‘monetary phenomenon.’”

“Accounting for the Secular ‘Decline’ of U.S. Manufacturing.” Milton Marquis and Bharat Trehan, Federal Reserve Bank of San Francisco Working Paper 2005-18, September 2005.

Despite a barrage of news stories that suggest domestic manufacturing is dying off, manufacturing continues to hold a central place in the national economy. Since the 1950s, manufacturing output has remained constant relative to overall GDP, for example, even as manufacturing employment and prices have dropped. This has fueled a debate about the relative causes: faster productivity growth in manufacturing or increased imports.

In a recent paper, Milton Marquis of Florida State University and Bharat Trehan of the San Francisco Fed argue that U.S. consumers hold the key to understanding this puzzle. They develop a model with two key characteristics: faster productivity growth and the unwillingness of households to substitute between services and manufactured goods. Together, the authors argue, these features of the model “can go a long way to explain” developments in U.S. manufacturing over the past 50 years. However, the model cannot account for several notable developments — for instance, the sizes of manufacturing employment drops in the late 1960s and early 1970s and again in the early 1990s.

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Three generations of Sandtown-Winchester residents: Janice Walker (center, top row), her grandchildren (clockwise from left) Kiera, Ashley, Cortany, Mikeal, Shanna, and Travon, and her mother Minerva Briscoe.

Family Portrait

Life is hard in one of Baltimore's toughest neighborhoods. But for Janice Walker, it's home

BY CHARLES GERENA

Editor's Note: *The following article on urban poverty approaches the topic from a different angle than most articles that appear in Region Focus. It does not explicitly discuss the public-policy issues at stake or proposals for reform. Instead, it tells the story of one family in Baltimore's Sandtown-Winchester neighborhood. This approach, we hope, will provide a broader understanding of the problems facing the urban poor.*

When tackling difficult issues such as urban poverty, one must be careful not to draw broad conclusions from

specific examples. We urge you to keep this in mind when reading this article. The family we profile is in many ways representative of households in Sandtown-Winchester and other communities throughout Baltimore. But, like all families, their story is unique.

Finally, we would like to thank Janice Walker and her family. They have very generously shared their thoughts, feelings, experiences, and recollections with us, so that we can share them with you.

Sheltering herself from the chilly November winds, Janice Walker stands behind a gated screen door on the concrete stoop of her house. She awaits the arrival of her six grandchildren from the community center across the street. It's almost dinnertime and it gets dark early.

Janice keeps watch over these children as well as many other neighborhood kids who hang out at her small three-story rowhouse every evening until their parents pick them up. They live in Sandtown-Winchester, whose 72 square blocks in west Baltimore are home to some of the city's most economically

PHOTOGRAPHY: SCOTT SUEHMAN

distressed streets. Janice has lived here almost her whole life.

By the time everybody gets home at 7 p.m., there are 10 children crammed into the small living room. Most of them squeeze into two leather couches around the TV to watch "Teen Titans." Mikeal, 7, sits on the floor beside a small round table while his older sisters, 13-year-old Kiera and 15-year-old Ashley, help Janice prepare dinner.

Tonight's meal is spaghetti and meat sauce. Each person gets a bowlful of pasta and a slice of garlic bread, along with a 32-ounce cup of punch-flavored soda. Four children eat at a wooden table tucked into one corner of the kitchen while six gather around a glass table with Janice. There are only four seats to go around in the dining room, so some of the kids use green, stackable patio chairs.

Janice Walker, 50 years old, makes \$12.25 an hour fixing sandwiches at the Terrace Court Café at Johns Hopkins University, working nine months out of the year. She became a mother at 16 and never finished high school. She describes her first husband as violent; her second died suddenly more than six years ago.

Janice's son, 33-year-old William, is serving a 35-year sentence for murder. Her 26-year old daughter, Cynthia, is a single mother of six who has been unable to hold down a job. Many of Janice's grandchildren have been in and out of foster care and none of their fathers is consistently in the picture. So, Janice feeds, clothes, and shelters six of her grandchildren, ranging in age from 6 to 15 years old. Three are from her son's side (though Mikeal is actually not a blood relative) and three come from her daughter.

For Janice, it was a choice between making room in her rowhouse in Sandtown-Winchester and letting the kids go into foster care. "I don't think anyone with a heart and a conscience could do that," says Helen Causion, one of Janice's three sisters. "Janice wouldn't have been able to sleep at night."

Family members pitch in whenever

they can, plus Janice has medical insurance and receives food stamps and some cash assistance from the Baltimore City Department of Social Services. But she is laid off from her job every summer, so her compensation falls below the poverty threshold of \$27,159 for a family of seven.

Janice puts off dealing with an inner ear problem she developed a few years ago or following up on a diagnosis of heart palpitations. Getting a GED or seeking opportunities beyond the backrooms of Johns Hopkins' dining halls isn't on her radar screen, either.

She says she's tied up with the kids right now, so she doesn't think much about what she'd like to do, other than maybe learn how to drive. Her sister, Causion, says otherwise. "There are times when [Janice] cries because she's tired. She wants a break and wants to do the things that we get to do."

Janice also chooses to remain in Sandtown-Winchester. In 2000, this African-American community had 52 percent of working-age adults not in the labor force. The median household income was \$11,000 less than the city median of \$30,000 a year, and one-third of homes are vacant. Single women head 64 percent of the households in Sandtown, while only

half the adults are high school graduates. The neighborhood is poor, and that's what makes it an affordable place for Janice to live.

"I'm not going to go somewhere and live beyond my means," she explains. Janice has a checking account and a small nest egg to cover home repairs, and no credit card debt. She owns no car, relying instead on friends or public transit to get around. "I can afford this house ... and still manage to get extra things." She has a cell phone, for example.

Janice's family is close by. Her mom and her sister Cynthia are less than a mile away on Division Street. Many of her friends live in the neighborhood, and she has come to depend on local resources like the health clinic on Division and the community center across from her house on Mount Street. This past holiday season, someone submitted her name to St. Gregory the Great Catholic Church to receive a basket for Thanksgiving.

Her home is part of a revitalization effort that has slowly spread through Sandtown since the late 1980s. Even so, the neighborhood has a long way to go. Police cars patrol the streets while video cameras mounted atop light poles keep watch over hot spots. This fall, officers

Baltimore/Sandtown-Winchester

The 72 square blocks that make up Sandtown-Winchester are home to some of the poorest streets in Baltimore.



scared Janice's mother out of her sleep after mistakenly kicking in her door. Janice makes sure that the kids go straight from school to home to the community center, keeping them off the streets where she and her sisters saw their share of drug dealing and spilt blood over the past 40 years.

Janice knows she's poor and has learned to accept that. "You're used to not having certain things. But you make sure you have your basics," she explains. "With me, I make sure that I pay all my bills. Once I get all of my bills out of the way, then I see where I can go from there. If there is something the kids need, I'll see what I can do. If I can't pay my mortgage and my gas and electric bills, that's going to be a problem. That means I have to get another job."

This is Janice Walker's life. It is filled with hostile surroundings and heartbreaking choices. It is ultimately about the difficulties in breaking the grip of poverty.

* * *

Janice has just finished loading a cart with tuna salad sandwiches when a co-worker pops her head into the kitchen. She asks if Janice can prepare today's special — a turkey chipotle sandwich — for the Megabytes dining area upstairs.

"Yeah, how many do you need?" Janice replies.

"Ten — we don't know how well it will move."

Janice reluctantly fills the order. "That's frustrating," she mumbles to herself. A few minutes later she is told to whip up another last-minute order for several smoked turkeys on focaccia bread.

Then Janice's cell phone rings. It's the nurse at Gilmor Elementary, one of the four schools that serve Sandtown-Winchester. Her granddaughter Kiera has a headache and needs someone to go home and get her some medicine. (Baltimore schools cannot administer medications without a parent's written consent.)

Janice asks the nurse to put Kiera on the phone. At first, she angrily

tells Kiera that no one is home to get her medicine and she can't leave work to do it. "I've got to make a living," she tells her. After listening for a bit, she offers to call a neighbor, but that's not good enough. Kiera hangs up.

Such confrontations come with the territory for a grandmother rearing six children on her own. "Sometimes I have to remind them who's the boss," Janice says. "But, on the same token, I let them know they can come to me and talk to me about anything. They tell me stuff that other kids' parents don't hear."

For example, Janice talks with Kiera and her sister Ashley about boys. She constantly tells the girls not to be pressured into having sex. "Don't let nobody tell you that they're crazy about you and madly in love with you, because it doesn't work like that," she says. She speaks, of course, from experience.

Janice also talks with her grandchildren about the importance of education. She hopes they will listen, even though she herself never liked school and chose to stay home at 16 with her newborn son instead of earning her high school diploma.

"The kids are always telling me that they want these high-priced jobs," Janice says. "Cortany talks about being a doctor. Well, she has to go to school to be a doctor. I tell them that so that they'll know that if they don't finish school, they're not going to be able to accomplish what they want."

Janice shows off the certificates earned by each child, proud of what they have achieved. "When Travon graduated first grade, I felt really honored," she recalls. "All of my fussing wasn't in vain."

During a recent homework session, Travon quickly loses interest in

For more than two decades, Janice has worked behind the scenes at the dining facilities of Johns Hopkins University.



what he is doing and starts looking through the sales sheets on the table. "Out of these pictures, what can you pat?" Janice asks Travon, trying to get him to focus. "What can you pat?" she repeats, patting herself on the head. "That's a pat." Travon looks blankly at his worksheet and points at a cat, but he calls it a dog. Then he calls it a map.

* * *

Janice and her three sisters were raised in and around Sandtown-Winchester. Today Janice lives only a few blocks from her childhood homes.

Growing up, both of Janice's parents worked. Minerva Briscoe, Janice's mother, says that her husband's bouts with alcohol abuse often forced her to carry the ball, however. "You couldn't find a better person than my husband Clarence," Briscoe says. "But he just loved to drink, he loved to drink. ... It got to be tiring."

Janice's father soon left the family. So Briscoe cooked homemade dishes at a popular local restaurant called Covington's, then worked at Western Electric. For the last 25 years, she has

been a cook at a home for abused and neglected children in Catonsville.

“Our father wasn’t in the home much,” Helen Causion says. “He left my mom to raise four girls on her own. We all learned to become independent enough to look out for one another.”

Back in the 1960s, Sandtown was just beginning its decline. Up to that point, it was one of Baltimore’s working-class communities for African Americans. Music spilled onto the streets from various night clubs and venues, including the Royal Theater where performers like Billie Holliday and Louis Armstrong played. (In fact, Holliday was born in Sandtown.) Briscoe remembers having a good time at the dance halls along Pennsylvania Avenue.

Then the assassination of Martin Luther King Jr. in April 1968 sparked riots throughout the nation. Baltimore was especially hard hit, particularly in the city’s western neighborhoods like Sandtown. The riots accelerated the flight of affluent residents to Baltimore’s relatively stable suburbs and exacerbated economic problems that were already developing in some communities.

Briscoe tried to shield her daughters from the growing criminal activity. Before it started getting dark, they all had to be back in the house. If anyone strayed away from the immediate area, she would come looking for them.

Briscoe couldn’t protect them from everything. Drug deals happened right outside their window. “We still saw a lot and experienced a lot at a young age,” Causion recalls. “We’ve seen people’s bodies laid out on the street and covered with sheets until the people from the morgue came to pick them up. ... We’ve had several relatives killed. [Our uncle] was killed by the police in a shoot-out right in back of our house.”

Briscoe didn’t let her daughters see their slain uncle. But she saw something just as bad. Two men standing on a street corner got into an argument. One decided to settle things

with a gun, shooting the other in the head. “People told me not to go up there, but I wanted to see,” she says. “This man lay out there. As he was breathing, blood was gushing up like a fountain out of his bullet wound. I was scared to go out of the house for months — all I could see was this man. I could imagine how people could be traumatized by seeing different things like that.”

While the sisters did what they could to keep an eye on each other, Janice assumed the role of mother hen since she was the oldest. “She made sure that we all got off to school because my mom had to leave for work early,” Causion recalls. “She did everything that my mom would have done. ... She was raised to protect.”

But she was still a kid. Janice admits to being “sneaky” as a teenager. Her mother describes Janice as being good-hearted, but temperamental and stubborn. Briscoe begged Janice to talk to her about sex, to no avail. “I was like, ‘How am I supposed to talk to her about that?’” Janice recalls. “And I didn’t go to her, either. That’s where I made my mistake.”

* * *

In 1971 at the age of 16, Janice began dating an older boy nicknamed Burl who she had a crush on. A few months later, Janice knew something was up.

“I started getting sick. I couldn’t eat and I couldn’t stand the smell of food,” Janice says. “I had no idea what was going on [but] my mother knew exactly what was wrong.” She asked one of her sisters if Janice was sleeping a lot and throwing up in the morning. When she said yes, her mother knew that Janice was pregnant. “That was the worst thing I could imagine.”

William Lewis was born in July 1972. Briscoe paid a neighbor to watch him; she wanted Janice to finish high school. But Janice kept skipping class to spend time with the baby and his father. “When I found out that bit of news, I told her, ‘Being that you’d rather be home with him

and be a mother, if you want somebody to watch the kid you’ll have to pay for it.’” Briscoe stopped paying for a babysitter and, eventually, Janice dropped out of high school.

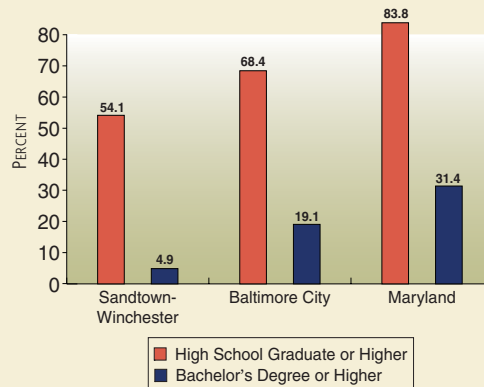
Janice never returned to school and is the only one among her sisters without a diploma. Helen Causion and Sharon Adams earned degrees from Coppin State University. Today, Causion is an executive assistant at Johns Hopkins Community Physicians and lives in Owings Mills, an affluent community north of Baltimore. Adams works at Bank of America as an analyst and lives in a predominately white neighborhood in northeast Baltimore. The third sister, Cynthia Briscoe, graduated from Carver Vocational-Technical High School and currently works at the state’s Department of Juvenile Services. She still lives in Sandtown.

Janice moved out of her mother’s house in the mid-1970s. She never married the baby’s father, though he tried to help out for a while. Eventually, though, he became part of Sandtown’s drug scene and wasn’t in any shape to help anyone. (These

Poverty and Education

Almost half of the adult residents in Sandtown-Winchester haven’t earned a high school diploma, while less than 5 percent have gone on to college and graduated.

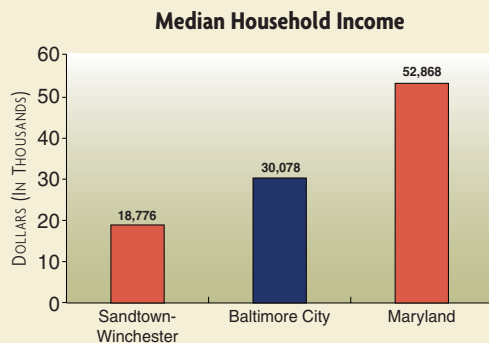
Educational Attainment, Population 25 Years and Over



NOTE: Sandtown-Winchester data is for Census Tracts 1501, 1502, 1601, 1602, 1603, and 1604, some of which cross over into surrounding communities.
SOURCE: U.S. Census Bureau, 2000

Poverty and Income

Households in Sandtown-Winchester earn substantially lower amounts than those in Baltimore as a whole and Maryland.



NOTE: Sandtown-Winchester data is for Census Tracts 1501, 1502, 1601, 1602, 1603, and 1604, some of which cross over into surrounding communities.

SOURCE: U.S. Census Bureau, 2000

days, Burl visits Janice on occasion to fix things around the house.)

Then in 1978 she married a man named George. Moneywise, it was perfect timing. “Financially, I didn’t want for anything,” Janice says, although she continued working.

Since George didn’t have any kids of his own, Janice tried to get pregnant again. Janice gave birth in 1979 to a daughter, Cynthia, named after her sister.

Meanwhile, Janice’s marriage was falling apart. “George was a real violent person. ... He was one of those controlling men, and he was much older than I was.” They divorced in 1982.

Janice and her two children moved into their own place on Division Street, right down the block from her mother. They wouldn’t be alone for long. Her uncle’s two sons moved in, then her sister Cynthia when she lost her home to a fire, then her stepsister Pam when she was evicted from her house. Janice paid the bills by taking on multiple jobs.

Her co-workers at Johns Hopkins recall that Janice was difficult to work with when she started there more than 20 years ago. Longtime friend Gladys Burrell says she was put off when she met Janice. “Let me put it this way — saying she was a handful is

putting it mildly. She didn’t take any mess,” Burrell recalls. Now, “she has mellowed out so wonderfully. I prayed that she would calm down.”

In 1990, Janice re-married to a man named Larry Walker. In 1999, she was planning his funeral. He choked to death during a diabetic seizure. “It just tore her to pieces,” Burrell describes. Janice still visits Larry’s grave.

* * *

Janice moved into her home on Mount Street in 2004. She tried to buy one of the houses developed on Riggs Avenue by a partnership of the Enterprise Foundation and a coalition of Baltimore churches, hospitals, and union organizations called B.U.I.L.D. Each two-story house has large rooms and patches of grass in the back and front yards instead of concrete, perfect places for the children and Janice’s cook-outs. But the homes were snatched up before she could get one.

So, Janice settled on the Mount Street home, built in 1920 and sold by B.U.I.L.D./Enterprise Nehemiah Development for \$71,500 through a special first-time homeowner’s program. It has four bedrooms, two bathrooms, and a small backyard, including a tiny brick patio with just enough room to hold a grill.

When she bought the house, Janice assumed that its main residents would be herself and three of her grandchildren — Cortany, Shanna, and Travon, now aged 10, 8, and 6, respectively.

These are the children of her daughter, Cynthia. They first came to live with Janice five years ago, when Cynthia lost her job and started falling behind on her rent. Janice and one of her sisters gave her money, but they later found out that it was barely enough to cover past-due payments that totaled in the thousands. Cynthia eventually received an eviction notice, forcing Cortany, Shanna, and Travon to find refuge with various friends and relatives.

Although they had a roof over their head, Cynthia’s kids weren’t in the best shape and Cortany — then 5 years old — was missing kindergarten. Baltimore’s Department of Social Services intervened, taking the kids away from Cynthia and placing them with temporary foster families. Cortany and Shanna — just 3 years old at the time — stayed with one family while 1-year-old Travon went to a different family. “The boys don’t go with the girls,” Janice says.

Janice didn’t know how bad things had gotten until her daughter called her. “She said, ‘Ma, they’re taking the kids.’ I was like, ‘Huh? Who took the kids?’” Janice contacted the child protective services division and was told that Cynthia had said she didn’t know where Janice was. Within days, Janice was at the courthouse to claim her grandchildren.

“I was sitting there in the hallway, and Shanna and Cortany came flying towards me because they saw me,” Janice recalls. They immediately burst into tears. “Cortany said, ‘We don’t know where Travon is. I kept telling them to call you.’” Travon did show up minutes later, but they were still frightened. “They said, ‘Don’t let us go, grandma. Don’t let them take us back.’ The kids were stuck to me like I was a sticky trap. ... They wouldn’t let me go to the bathroom or nothing.”

Janice obtained custody of the three kids, bringing them home to live with a boyfriend whom they called “Mr. Charles.” But he wasn’t crazy about the idea of three youngsters living with him; his own children were already grown and out of the house. “It was too much madness for him,” Janice explains, so the couple went their separate ways, with Janice eventually settling in her current Mount Street rowhouse.

Janice hopes things will get better for her now 26-year-old daughter. Cynthia has taken parenting classes and says she is going to school, though she hasn’t said what she’s studying. She remains unemployed. “Cynthia hasn’t finished school, but there is so many things she could do,” Janice says. “She

knows how to do hair. She can do tattoos.” (In fact, Janice has a tattoo done by Cynthia, as do two of her other grandchildren, Kiera and Ashley.) Still, Janice is not overly optimistic.

Three more children joined the Janice Walker household just last year, these from her son’s side of the family tree.

William, 33, had been in and out of jail ever since he was a teenager. Helen Causion, who took him in for a while, says: “William was defiant and out of control. He wouldn’t go to school because he admired the guys who were out on the corner selling drugs and getting involved in all kinds of criminal activity.” She believes that William and Cynthia were enticed by the fast money of drugs and crime. “You know, there’s two things that come with that — jail or death. But they didn’t grasp that.”

William’s home today is with the Maryland Department of Public Safety and Correctional Services. He has served 12 years of a 35-year sentence for gun possession and second-degree murder. After his 1993 conviction, Ashley, Kiera, and Mikeal (now 15, 13, and 7, respectively) moved in with their mother, Carrie. (William and Carrie conceived Ashley and Kiera in between jail terms, according to Causion, while Mikeal is the product of a relationship between Carrie and another man. Carrie and William are now divorced.)

About a year ago, Carrie lost her job and apartment due to “circumstances beyond her control,” according to Janice, who agreed to take custody of the children because their other grandmother couldn’t take them in. Janice believes they would have been split up between different foster families if she didn’t step up, making it much harder for Carrie to get them back.

That is how six children ended up sharing Janice’s Mount Street home. Crowding is a bit of a prob-

lem but, mercifully, lead paint isn’t. Three of her grandchildren had elevated levels of lead in their blood from their previous home.

In addition to other pluses, the home is across the street from the Sandtown-Winchester Community Center. This imposing building was once part of Coppin State University. Then it was one of the first renovation projects of Community Building in Partnership, a coalition of local residents, city officials, and the Enterprise Foundation formed in the early 1990s. Now CBP operates the center, which remains under city ownership. Janice loves it.

“The children go over there and learn, play, and mingle with other kids,” Janice describes. Also, “sitting down to do homework with six kids was hard.”

Within the building are a variety of after-school programs, as well as a job readiness and placement program, and a Neighborhood Service Center that administers social services from the city of Baltimore. When Janice Walker broke her leg six months ago, a community center employee pitched in by taking her back and forth to the doctor and doing other things.

On a brisk fall morning, Janice takes the day off from work to tend to “family matters.” Kiera and Mikeal have a date with a dentist to check on their fillings. Then, they will go with Ashley for a trip downtown to the courthouse. A judge will determine whether the three children will be returned to the custody of their mother, Carrie, William’s ex-wife.

But first, they all have to get to Total Health Care in time for a 9 a.m. appointment. Janice hustles the kids out of the door at 8:30 a.m. so they’ll have plenty of time to walk the dozen or so blocks to get there and beat the crowd. The community health center on Division Street is funded with public grants.

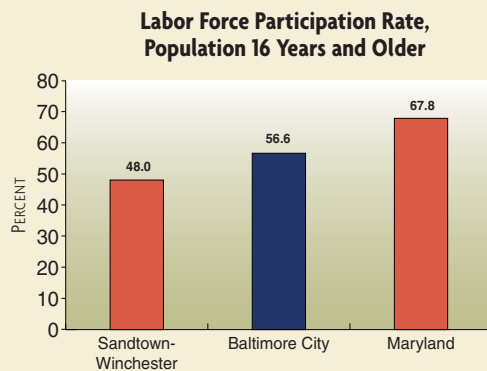
Janice and the kids take Riggs Avenue most of the way to Division Street. They’re too busy clowning around and laughing to dwell on the stark contrasts between new housing, rundown buildings, and vacant lots that await redevelopment. One of the kids does make a big production out of spotting a dead rat in a gutter. “Don’t touch that,” Janice admonishes. “It could have disease. Don’t ever touch anything like that with your bare hands.”

Nor do they pay much attention to a group of young men standing in the middle of an intersection. But the men notice the two adolescent girls. Kiera is wearing jeans and a pink jacket with grey stripes on the sleeves. Her hair is neatly braided, though she complains that it feels too tight on her head. Ashley is also wearing jeans plus a pair of sneakers with rust-colored accents that coordinate with the brown and white stripes on her layered shirt. On top of the shirt is a jeans jacket that is cut off at the midsection. Her hair is tightly pulled together to form puffs on either side of her head.

“Good morning, ladies,” a few of the men say. Janice replies with a terse “good morning” without making eye contact. Once they

Poverty and Labor Force Participation

Sandtown-Winchester residents seek work at much lower rates than their counterparts across the city of Baltimore and Maryland.



NOTE: Sandtown-Winchester data is for Census Tracts 1501, 1502, 1601, 1602, 1603, and 1604, some of which cross over into surrounding communities.

SOURCE: U.S. Census Bureau, 2000

are beyond earshot, she disparages the group for just hanging around all day. "Why are they standing in the middle of the street like that?" she tells her grandchildren. "They need to get a job."

Even with these diversions, plus a quick break to pass around a pack of gum, Janice manages to get everyone to the clinic with 15 minutes to spare. The good news is that barely anyone is waiting at the check-in desk or at the dentist's office upstairs. The bad news is that Kiera's Medicaid health insurance hadn't been renewed.

Without the coverage, the appointment will cost \$40. Janice hasn't received her paycheck yet. The clinic can send her a bill, but Janice decides to reschedule the appointment instead. Kiera's mother, Carrie, could soon be regaining custody, so Janice figures the bill is her problem.

"It could be a year before it gets done," Kiera complains, disappointed that only Mikeal will see the dentist today. Janice replies that her mother will make sure that her teeth are taken care of too.

"And why does it have to cost so much?" Kiera whines. "Because the doctors have to get paid for the work they do," Janice answers. "People have to work to make money."

After the dentist, Janice takes the kids home for a quick breakfast and a respite before heading to the courthouse. Kiera and Ashley take turns cooking up some scrambled eggs and a couple of thick pork sausages for everyone to eat. Invariably, the smoke alarm goes off and someone rushes to plug in the box fan sitting between the kitchen and the dining room.

Kiera makes a quick wardrobe change and unties some of the braids in her hair before the family embarks on the long trip ahead of them. They walk east to the Upton/Avenue Market subway station on Pennsylvania Avenue, with the kids goofing around loudly every step of the way.

Janice stops at a corner store to make a quick withdrawal and buy

a few things. The store isn't much to look at from the outside, and it's even dingier inside. Bulletproof glass divides the small store in half, leaving a narrow space for customers on one side and a narrow counter area for the two Asian workers on the other side. The walls behind the counter are filled with goods, mostly shelves with various permutations of alcoholic beverage. A mini-ATM is crammed into one corner and several video games line the adjacent wall, including a video slot machine that has the complete attention of an older man.

While Janice withdraws money from the ATM, the kids occupy themselves. Mikeal fiddles with the large, bright buttons of a casino game without putting in any money, while the girls decide what they can buy with the \$5 they have to spend. They ask Mikeal what he wants and end up buying a bottle of soda, candy, and an "onion pickle" stored in a plastic bag. While riding the train and bus, the kids pass around the pungent slices of pickle to eat.

It takes about an hour to get from Janice's home in Sandtown to the Juvenile Justice Center downtown. The subway ride to the Lexington Market stop is pretty quick, but it takes awhile to transfer to the #15 bus that goes to the courthouse.

Music blares from a clothing store across from the bus stop, prompting Ashley and Kiera to show off their latest moves. Janice recognizes a few of the tunes, but leaves the monkey business to the girls. "Wiggle it, wiggle it, and jiggle it," Ashley keeps singing, long after the tune has stopped playing.

As the kids' boredom grows, they start playing around with the onion pickle because nobody wants to get the juices in the bag on them. At one point, Ashley tries to slip a piece of pickle into Janice's mouth. Janice pushes Ashley away as soon as the pungent taste hits her mouth. She warns them that they'll go back home and miss seeing their mother, Carrie, if they don't calm down.

* * *

Janice meets up with Carrie on the second floor atrium of the Juvenile Justice Center. They sit on one of the wooden benches near the windows overlooking North Gay Street. Others are sitting nearby or milling around, cooling their heels until they have to walk down one of the many long corridors to the courtroom where someone's fate will be decided.

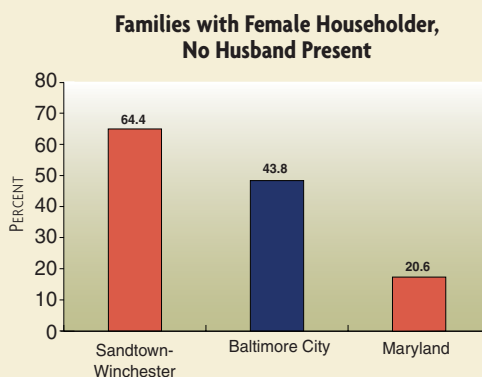
Carrie dotes on Mikeal, kissing him on the forehead and checking his ears to make sure they are clean. She asks Ashley to get a wet tissue so that she can clean him up, which just makes her mad. Ashley defiantly thrusts the palm of her hand at her mother's face and walks toward the bathroom.

Ashley's mood has changed completely. Until now, she has been animated, outgoing, and full of energy. But when she comes back and hands over the tissue, Ashley silently plops down on the next row of benches. Her tattooed back is turned from Carrie and everyone else sitting behind her. (The tattoo is Carrie's name.)

Ashley opens up a plastic grocery bag full of papers and pulls out an orange report cover with her name written across the front in big letters. She flips past a

Poverty and Single Parenting

Sandtown-Winchester has a disproportionate number of families headed by a single mom.



NOTE: Sandtown-Winchester data is for Census Tracts 1501, 1502, 1601, 1602, 1603, and 1604, some of which cross over into surrounding communities.

SOURCE: U.S. Census Bureau, 2000

few pages of artwork and poetry, then finds a blank page and starts doodling.

Meanwhile, Carrie talks with Janice about whether the kids will stay with her so they can continue to go to the same schools. Janice reminds Carrie that the whole point of her taking the kids was to give Carrie time to get her life straightened out.

The family was told to be at the courthouse at 1 p.m., but several hours elapse before a lawyer finally stops by to fill everyone in. The details are still being worked out, but it looks like there should be no problem transferring custody of the kids to Carrie — she has a steady job at a local dollar store and a place to live. Privately, Janice doesn't think Carrie realizes what she is getting into.

The group takes a long walk to one of the overbooked courtrooms and waits for Ashley and Kiera's case to be heard (their case is separate from Mikeal's). They create such a loud ruckus in the hallway that an officer comes outside and tells them to be quiet. That admonishment doesn't go over too well — Carrie wonders out loud why the "rent a cop" was harassing them.

Later, Carrie grabs Mikeal and scolds him: "If you don't cut it out, you're not getting anything from me." Mikeal whines and continues acting up.

In the first juvenile court case involving Ashley and Kiera, the judge — called a master in this setting — must sign off on an order of supervision that allows the girls to live with their mother. The mother must provide access to her home for visits from social workers until the supervisory period is over. Then, they will go back to court in March to finalize the transfer of legal custody from Janice.

The whole process seems quick and painless, except for when Janice's son, William, is brought into the courtroom in order to provide his consent for the agreement. He enters wearing a plain shirt and

sweatpants, and shackles around his ankles and hands. He sits quietly on a bench to the right of the master, but flashes a quick smile and waves at his family in the rear of the courtroom. Ashley glares back, sitting huddled against the wall in the last row of benches.

Seeing her father in shackles is apparently too much for Ashley to bear. A short time after leaving the courtroom, she slumps down against the wall and starts sobbing. Janice rushes over to offer comfort while the others — including her mother — watch from nearby. She whispers softly to Ashley for a little while and caresses her face. Once she manages to get a laugh or two from Ashley, she pulls her up from the floor and tells her it's time to go on.

The group trudges over to the next courtroom where Mikeal's case will be considered. While waiting in the hallway, Ashley walks up to Janice, stands nose-to-nose with her and asks, "You're going to miss me, aren't you?" Janice replies playfully that she won't miss her one bit, but Ashley insists that she will and throws her arms around Janice, dragging her to one side.

The second case is over just as quickly. The master rescinds an order that made Janice the little boy's legal guardian. Carrie whisks away the kids, who barely have a chance to say good-bye to Janice before they rush off to the subway. Kiera and Mikeal will come back to Janice's house to live until the school year is over, visiting their mom on holidays and weekends. Ashley will box up her stuff to move in with Carrie right away. For now, it's after 5 p.m. and everyone is starving for dinner.

Janice is left alone in front of the courthouse. It has been a long day of sitting and waiting and nodding off.



Janice walks to her house with Kiera, Ashley, and Mikeal to grab a quick breakfast before heading downtown for the children's custody hearing.

But she is relieved that some responsibility will be taken off of her shoulders.

As the evening approaches, Janice rushes back to the train station on Charles Street to catch the train home so that she'll be there when the other grandchildren leave the community center. She has worried all day about the kids getting to the center safely and talked to someone on her cell phone a couple of times about it.

Walking back to her house, Janice stops to talk to a couple of boys sitting on the steps of the makeshift church next door, a rowhouse converted for that purpose by two simple additions: a wooden cross attached to the front and cling-on decals in the windows that look like stained glass. "The girls are going home to their mother," she tells them, so they won't be around as much to get into arguments.

With that, Janice drags herself up the steps and unlocks the security door. In the back of her mind is following up with a doctor about her dizzy spells and heart palpitations. Right now, she has to start dinner to feed her charges and other neighborhood kids. She'll put off taking care of her problems until after Thanksgiving. **RF**

PHOTOGRAPHY: CHARLES GERBAM



Amid mounting competition, broadcast TV stations like WRAL-TV in Raleigh are committing to local news as their ticket to profitability — and durability

BY DOUG CAMPBELL

It's 9:15 a.m., Wednesday, Nov. 2, inside the crowded news conference room at WRAL-TV, Channel 5, the CBS affiliate in Raleigh. Huddled around a bare table are 12 people — producers, reporters, and various other news employees. At one end sits Steve Abbott, the assignment editor, tapping away at a computer keyboard. Standing by the doorway are three other reporters, notebooks in hand, waiting to pitch their stories.

The WRAL team — motto: Coverage You Can Count On — has already aired three hours of local news today, beginning with the morning broadcast at 5 a.m. (In an unusual relationship, WRAL also produces newscasts at 7 a.m. and 10 p.m. for its sister station, WRAZ-TV, the Fox affiliate.) Next up is a half-hour at noon. Right now, the focus is on the centerpiece evening newscast — and it's pretty clear that today is *slowww*. Yesterday, a member of the state's newly formed lottery commission was forced to step down, but the item was already all over the morning papers. There's a debate over a landfill in a nearby suburb, but it's been going on for weeks.

Miriam Sutton, an evening newscast producer, walks over to an easel in the corner. A white paper sheet lists all the reporters working that day and the stories that are likely to get on the air. So far, just three reporters have assignments next to their names.

Then reporter Amanda Lamb steps into the room. There's some new information about a recent arrest in an old local murder. It turns out that investigators from Michigan are coming to town for interviews, her sources say.

Across the table, Melissa Buscher stands up. She's also on this story. "We're going to work the phones," she says. At the very least, they expect to get enough for a "V.O.," or voice-over segment. Lamb agrees but is more insistent that this is big. She lays out her theory that the region may have a serial killer on its hands.

To this, Jim Hefner, WRAL's general manager, guffaws. "You've watched *Law & Order* too many times," he says. Lamb doesn't miss a beat: "I love this story," she says, and then adds with pride: "The paper today had stuff that we already had on Monday."

The meeting continues for another 30 minutes. In a good way, nobody

seems to be in charge, and people in the room variously get up and leave or start side conversations. A reporter pitches a story about a quirky state law that may leave motorists liable in accidents where they weren't really responsible — but nobody is too keen on this for today. Ditto for a possible look at a high school policy for athletes that appears harsher on cigarette smokers than illegal drug users. A drive-by house shooting is rejected when it comes out that the home's occupants shot back.

After awhile, people whose questions have been answered simply get up and leave. By 10:05 a.m., two producers remain, filling in the final holes on the day's lineup.

This scene would not seem out of place in any number of media newsrooms. What happens at WRAL every day — from reporters pursuing stories to directors precisely punching buttons in the control room — is simply what happens in producing local news.

But what's happening at WRAL-TV is growing uncommon. In a time when budget cuts are squeezing TV newsrooms, WRAL is letting two reporters chase the same story, one

that may not even be worthy of airtime tonight. The company that owns WRAL is no national conglomerate; it's locally owned. The GM, at many stations simply a salesman with little to no background in news, is himself a former news director and sees fit to spend almost two hours each day in the newsroom. Sure, many of the pitched stories are of the "if it bleeds, it leads" variety, but just as many are wonkish government agency stories that usually are anathema on TV.

This is a calculated strategy. WRAL is the top-rated station in the Triangle, No. 1 in the most important news slots, and the leader in market revenues by an estimated 16 percent margin. Broadcast TV stations operate in an environment where being a clear No. 1 or No. 2 in the market increasingly is the only way to afford producing local news. And on the flip side, only local news can generate sufficient revenues to keep a station atop its market in ratings. "Even the consultants seem to recognize that to survive, local TV news must move beyond just presenting the news well," authors with the nonprofit watchdog group Project for Excellence in Journalism concluded in their 2005 "State of the News Media" report. "The news itself must become more relevant and more substantive."

The Market for News

Local TV news faces a number of challenges. Not too long ago a federal license to broadcast TV was akin to a license to print money, but that's no longer the case. The growing number of "substitutes" offered to people who otherwise might watch TV is the biggest threat. Twenty years ago, stations didn't even have to be that good at producing local news to guarantee strong revenues and profits because local advertisers seeking a mass audience had nowhere else to turn. Nowadays, mounting competition ranges from cable TV to the World Wide Web, plus innumerable other leisure pursuits. "Our competition is any activity which uses time," says Hank Price, a senior fellow at the Media Management Center at

Northwestern University and general manager at WXII-TV in Winston-Salem, NC. "Your chief competition at 11 o'clock is people going to bed."

Yet for all these difficulties, TV broadcasters maintain certain clear advantages. They remain one of a handful of media that can deliver big regional audiences; even the 5:30 p.m. broadcast at WRAL is seen by 128,000 people, or nearly 10 percent of the entire Triangle market. During the course of any day, local TV news reaches a much bigger audience than, say, the local newspaper. They also face no threat of new entrants in their business — the number of over-the-air broadcasters is strictly limited by the laws of physics and the FCC. Practically speaking, that number usually confines to no more than three and sometimes four competitors who can offer what remains the No. 1 draw of local TV audiences — local news.

Also competing in the local news market are newspapers and radio stations, along with Web sites. All market participants have suffered audience declines in the past decades. However, it's worth noting that TV news operations appear to have stabilized their viewership in recent years, with about 59 percent of Americans now saying they are "regular" watchers of local TV news. By comparison, the percent of people calling themselves "regular" newspaper readers continues to fall, according to the Pew Research Center for the People and the Press. And in terms of attracting the coveted young audience, almost half of 18- to 29-year-olds polled by Pew say they watch local TV news — compared with just 23 percent who say they read newspapers.

"Local news can be a real moneymaker for a station. It all depends on how successful they are in attracting audiences," says Mark Fratrick, vice president at BIA Financial Network, a media consulting business in Chantilly, Va. "The classic example is WRAL in Raleigh. They are local news in Raleigh."

10:10 a.m.

Cherie Grzech, assistant news director at WRAL and late of a Chicago

newsroom, scans the spare list of green-lighted stories. "This is going to be a fun day to put this board together," she says sarcastically. Grzech paces into her windowed office. She is one of only a few newsroom employees with an office whose door closes; one other is Rick Gall, the news director. (Even the anchors, whose low-six-figure salaries are the largest in the room, settle for their own cubicles.) Grzech swings her chair to her computer screen as a morning-side reporter, Megan Hughes, drops in to go over a script. Grzech reads aloud, scrolling, typing and trimming. "Why do your scripts never look long but always run so long?" she scolds. Hughes laughs and scoots out of the office. She's been at work since 3 a.m. (The biggest growth in TV news over the past decade has happened in the mornings, with two-hour chunks of local news preceding the national network morning shows.)

Why did Grzech leave a high-profile position in Chicago, the third-largest TV market, to come to Raleigh, No. 29? "I came here mostly for what this station stands for," she says, and on her fingers ticks off a mental inventory: a newsroom of 100 people, a dedicated helicopter, low turnover, and — most important — strong and direct backing from the ownership that local news is what drives everything at WRAL. "It's everything you get into journalism for and you don't find it in many local stations."

Unlike some other media, there is a vast amount of instant, quantitative feedback in TV. Every day, stations get e-mailed their "overnights," or viewership numbers from the day before. WRAL generally leads its time slots, though competitors in morning news are pretty close. In print media, such attention to audience is unusual and even disdained. Grzech sees it differently: "The beauty of this station is we can do everything the way we want to do it and still win. Most stations are thinking about contests and gimmicks. We had a meeting about the November book (the fall edition of the quarterly Nieslen ratings period that is crucial in



Above, assignment editors can survey the entire WRAL newsroom, listen to police scanners, and coordinate reporters and camera crews. Right, WRAL-TV begins the day with its first news report at 5 a.m. Morning broadcasts have seen the biggest growth in local TV news over the past decade.



determining advertising rates), and we decided we weren't doing any promotion pieces. We're doing good stories every day like we always do."

11 a.m.

Steve Abbott prepares "The Split Sheet for Wednesday, Nov. 2." The left-hand column lists the day's remaining newscasts at noon, 5 p.m., 5:30 p.m. and 6 p.m.; the right-hand column is a list of voice-overs that can be used in each segment, ranging from "Map Hanes Job Cuts" to "Warren Animal Shelter." Abbott is the assignment editor and his desk is on a raised platform in the corner of the newsroom. From his seat he can peer directly into each cubicle, making it easier to know who's available. It's loud, what with several police scanners constantly blaring.

The noon producer, Scott Nagel, steps up to the desk. He's looking for anything resembling breaking news to fill out his slot and notices the most bustle happening at Buscher's and Lamb's cubicles. It's his job, for example, to write the scripts that anchors read on their teleprompters, endlessly teasing forward to the next, must-see story or segment. "What's every-

body atwitter about?" Nagle asks Abbott. Upon hearing about the possible serial killer angle, Nagle walks

over to the investigation team.

WRAL has producers for eight distinct news shows each weekday: From 5 a.m. to 7 a.m. on WRAL; from 7 a.m. to 8 a.m. on WRAZ, the Fox affiliate; from noon to 12:30 p.m. on WRAL; from 5 p.m. to 6:30 p.m. (in half-hour increments) on WRAL; from 10 p.m. to 10:30 p.m. on WRAZ; and from 11 p.m. to 11:30 p.m. on WRAL. Hefner says that adding WRAL news on sister station WRAZ, which is also owned by Capitol Broadcasting, was not a budgetary decision. "WRAL News is a strong brand in the Raleigh market. Rather than try to recreate a brand, we are exploiting it on another station," Hefner says.

That said, the economics of adding more hours to the daily newscast offerings are undeniably favorable, since only a handful of extra staffers and basically no extra equipment are required to do so. The same logic applies for the relatively recent innovation of two-hour local newscasts in the mornings. "The more we expanded, the more we saw an appetite for local news, especially in the morning," Hefner says. "TV had left this time period to radio until about 20 years ago."

A Word from Our Sponsor

Local television stations make money in two main ways: local "spot" advertising and national spot advertising. (In both cases, the automobile industry is the dominant advertiser.) "Spot" means that advertisers are buying only in specific markets, rather than blanketing the United States with commercials.

National spots are usually brokered on stations' behalf by rep firms. For reps, it's all about ratings — stations that can deliver the biggest audiences in the most desirable demographics get to charge a premium for their time. Hence the allegiance to the almighty Nielsen ratings book.

The other half of station revenues derive from local spot advertising, and here stations like WRAL can gain a distinct advantage. In times of big news events, ratings tend to spike for stations with reputations for covering breaking important stories well. But those stations' competitors don't usually experience a similar bump in viewership. In other words, a rising tide doesn't necessarily lift all boats.

"We all work for the news department, ultimately," says Quinn Koontz, WRAL's director of sales. "That's what our reputation is based on."

The audience for news is particularly appealing to advertisers. News watchers, TV managers say, tend to be better educated and better paid than other viewers. So even though it might be a lot cheaper to air reruns of the "Andy Griffith Show" — and get a decent audience share — the returns from a half-hour of more expensive to produce local news are far higher.

Jim Hefner has been GM at WRAL since 2001. This is his third stint at the station; in one incarnation he was news director. To him, it's a no-brainer that WRAL is concentrating on news: "You don't have any choice. The one thing we can do that a cable channel can't is

local news." Yes, it costs more than airing syndicated programming, but stations relying on reruns of "Seinfeld" or talk shows don't get the ratings WRAL does, and that's not at all unique. "You look at the No. 1 station in any market, and it is the station that has made a commitment to local news," Hefner says. "It doesn't matter what the network affiliation is. It doesn't matter what happens in prime time. It's the guy who runs that station who understands the importance of local news. Those of us who have figured it out are doing well."

This is true to a point, but it is hard to know whether "quality" news programs outperform those of lesser quality, since this is a subjective measurement. One important indicator may be how a station's other programming performs relative to news. While WRAL is consistently No. 1 and does attract some viewers who switch from other channels just to watch the news, its day-by-day performance depends somewhat on lead-in network and syndicated programming. For example, its market share is visibly higher on nights when CBS network programming is strongest, such as Monday and Thursday.

How well does all this translate into financial performance? Hefner won't say precisely. BIA Financial estimated WRAL's revenue in 2004 at \$50.7 million, making it No. 1 in the market by more than \$8 million. In all likelihood, the station is also very profitable. Nationally, average profit margins for local TV stations are estimated at more than 40 percent. (2005 is expected to be a down year from 2004 primarily because of the absence of a national political campaign, whose ad dollars helped lift national TV ad spending by about 10 percent.)

The lion's share of the revenues derives from the evening newscasts, chiefly at 6 p.m. and 11 p.m. At WRAL, a 30-second commercial during the 6 p.m. news was going for \$1,400 in November; at 11 p.m., it was \$1,500. Both rates are presumably higher than market competitors because WRAL can deliver a larger audience. Though newscasts take up typically about five hours

of a station's daily programming, they account for almost half their revenue.

The growing number of substitutes for obtaining local news — and entertainment in general — is taking a toll, however. The bottom line is that audience shares for TV evening and late news fell 16 percent and 18 percent, respectively, between 1997 and 2003. This shrinking revenue pie is prompting some stations to bail out of local news.

"If you're not No. 1 or a strong No. 2, you need to look at different business models," says Price, the Northwestern media fellow. "We're in a transition period in TV, from the old way to the new way of doing business. In the future, we'll have fewer stations doing local news."

The Talent

In the unofficial hierarchy of newsroom employees, anchors are at the top. They are the public face of the station. Hiring an anchor is perhaps the biggest decision station management makes. On-air talent in major markets is usually represented by an agent and locked in for two- and three-year contracts, with no-compete clauses. In a market like Raleigh, anchors can expect to make in the low-six figures.

Pam Pulner, a Washington, D.C.-based agent, represents one of WRAL's evening anchors, Gerald Owens. Pulner has been in the business for more than two decades and says that, despite all the effort that may go into producing local news, success often comes down to the truism that "people watch who they like. If the station has the best weather equipment — it doesn't matter. If you're not drawn to that person on the TV, then when it's time for the news, will you reach for the remote and turn to that person? There's a lot of work behind the scenes that goes into making sure that a station has the people who will make you do that."

(This lesson is also key to understanding the central role that weather continues to play in local newscasts. Weather tends to account for as much as one-fifth of any half-hour of local news, even on days when it's sunny and

72 degrees. "Weather is the single most important element in any newscast," says WRAL GM Hefner. But in a world where up-to-the-second weather updates can be found on the Web and cable channels, and every local station airs virtually the same forecast, the enduring appeal of the local TV news weather team might seem like a bit of a puzzle — until you factor in personality.)

As an anchor, Owens is both a late-bloomer and a natural. He worked in plastics for 13 years before deciding that his good looks, baritone voice, and inquisitive personality suited him for TV news. He rose quickly, landing as anchor of a morning news show in Washington, D.C., just a few years into his broadcast career. Owens came to WRAL three years ago, deciding that moving to a smaller market was worth it because of the reputation of WRAL and the de facto promotion to evening news anchor. Walking around town with him is an event. He draws a lot of stares. His is one of the region's most instantly recognizable faces, trailing perhaps only Mike Krzyzewski or Dean Smith. Also, he tends to stand out in a crowd thanks to his 6-foot, 6-inch frame.

Most anchors earned their stripes as reporters. To land the desk job requires a unique personality, a face that at once conveys authority and affability. Owens has both. He actually enjoys meeting fans, shaking hands, and signing autographs. If you don't appreciate that sort of thing, Owens contends, you ought to get out of the business. If viewers sense that anchors feel superior, "they'll watch someone else."

1:45 p.m.

The afternoon news meeting is under way. There's been a fire at a Durham business, but the helicopter shots show only charred remains, not flames, so interest is low around the table. Duke Energy is reporting profits today; that'll get a voice-over. Bonnie Moore, the managing news editor, is pushing the tree-trimming story, arguing that it looks like a neighborhood has been clear-cut. "It's a visual story. This is television, folks!" she says.

WRAL's team prides itself on offering up serious news. But this group isn't above trotting out "news you can use" staples. (And, yes, WRAL employs one of those ubiquitous "On Your Side" reporters full-time.) One segment getting play this week is about how several WRAL staffers are trying to lose 10 pounds each. Another is on blogging in the workplace, a piece which relies in part on thinly disguised promotional interviews with WRAL employees who keep personal blogs. (Or, if it wasn't supposed to be promotional, it wasn't very aggressive reporting.) And despite avowals of paying sharp attention to capital politics and government, on this day most newscasts begin with a crime scene.

That is in keeping with national pattern. According to the Project for Excellence in Journalism, "public safety" news accounted for 61 percent of the opening segments on newscasts between 1998 and 2002, and overall made up 36 percent of the entire broadcasts. It's a "hook and hold" brand of news, according to the Project for Excellence in Journalism, and the reason for so much sameness among local TV news broadcasts. As an economic incentive, crime stories tend to be easier to find and promote, thereby pushing stories of possibly greater significance deeper in the newscast where they get shorter airplay.

WRAL staffers uniformly say they came to this station in large part because they wanted to escape the traditional trappings of TV news. They tell dark tales about their former jobs at chain-media outlets. WRAL, in contrast, is locally owned and family operated by Capitol Broadcasting Co. More to the point, it's presided over by Jim Goodman, CBC's chief executive and the reason virtually every WRAL employee mentions as at least part of their motivation for hiring on here.

Goodman (who is a former director of the Richmond Fed's branch in Charlotte) is a Raleigh native whose grandfather, A.J. Fletcher, in 1937 launched the WRAL empire in picking up a 250-watt AM radio station. CBC now owns several TV and radio sta-

tions, the minor league Durham Bulls and various real estate holdings. But WRAL is the flagship and Goodman's personal baby. In 2003, he railed against proposed new FCC rules to raise the ownership cap from 35 percent of the nation's households to 45 percent, in addition to allowing companies to own multiple stations in a single market. He said it would be "the death of localism." Given the competitive environment that WRAL operates in, this view is consistent with the interests of the station.

In contrast to Capitol Broadcasting, ownership of most TV stations nationwide is big business. According to the Project for Excellence in Journalism's report, *State of the Media 2005*, in 2003 the 10 largest TV station owners had 299 stations with \$11.8 billion in revenue, almost half of all TV station revenue total. Those are companies with the financial wherewithal to move into a market like the Triangle with a vengeance and make competition even tougher for WRAL.

4:58 p.m.

The weekday anchors take their seats — Pam Saulsby, David Crabtree, and Debra Morgan. They flip open laptop computers and chat with producers, directors, and others whom they hear via earpieces.

The control room has 55 TV screens stacked against the far wall. Everybody in the control room faces those screens, their backs to a wide window that opens into the studio. "Amanda is next," says a calm Michelle Fauver, the 5 p.m. producer and one of four people in the control room. (The others are the director, the graphics coordinator, and the teleprompter feeder.) An almost quaint "On the Air" light, with accompanying picture of microphone, is mounted high on the left wall.

Everything is humming along glitch-free until about 5:16 p.m. when a reporter calls in to say he wants to go live at the scene of a possible drug-lab bust. This requires Fauver to execute a number of hairpin moves. She must alert the QC, or Quality Control, room to re-steer the station's satellite to pick

up the incoming live transmission. "Where's Stoooge?" she says, sounding increasingly harried. She is looking at a small screen to her right that will show her reporter Jason Stooogenke, who is out at the scene of the drug bust. So far, it's just snow. "There's still no Stoooge," Fauver says into her microphone, simultaneously pressing a button that allows her to speak with anchors. "As scripted, Deb does the tease." She stares at the screen for a few seconds, seemingly not breathing. "I hate breaking news!"

At 5:25 p.m., an at-first blurry image of Stooogenke materializes on Fauver's screen. "Breaking news, if you've got it," Fauver orders the graphics coordinator. She presses a button. "Jason Stooogenke, possible methamphetamine lab, police on the scene," she says. The "Breaking News" graphic flashes across the screen, with complementary dramatic music, and Saulsby looks up at the camera: "Breaking news in Cumberland County where Jason Soogenke is with police on the scene of a possible methamphetamine lab."

Fauver raises a fist: "Nice!" It's 5:27 p.m., and her job is done for the day, stepping aside for the next producer, Miriam Sutton. "Perfect, great job, bye-bye."

The next hour is unremarkable. There is no "breaking news" to muck up the scripts. Meteorologist Greg Fishel delivers three nearly identical forecasts in a row (no rain for a long time). Tom Suiter rattles off some sports highlights, expertly removing, then donning his reading glasses as the camera goes off and on him.

At 6:32 p.m., the news staff, along with the technical personnel, gathers in the newsroom just behind the anchors' desk for a post-mortem. "I think we were good," Cherie Grzech says. That's the consensus, and a minute later they break.

By 9 a.m. the next day, the ratings are in.

5 p.m. to 6 p.m.: estimated 124,000 viewers, No. 1.

6 p.m. to 6:30 p.m.: 165,000 viewers, No. 1.

11 p.m.: 141,000 viewers, No. 1. **RF**

CURRENCY CONUNDRUM

Why Are Exchange Rates Out of Sync With Other Economic Indicators?

BY DOUG CAMPBELL

Flip to the section on exchange rates in almost any economics textbook and you will find one of the profession's most widely accepted notions on the workings of global trade. Gregory Mankiw's *Macroeconomics* puts it as plainly as any: "If the real exchange rate is high, foreign goods are relatively cheap, and domestic goods are relatively expensive. If the real exchange rate is low, foreign goods are relatively expensive, and domestic goods are relatively cheap."

It sounds so simple. An appreciating dollar, you would expect, would lead Americans to consume more foreign products relative to domestic products. But, in fact, this often turns out not to be the case, at least in the short run.

Consider the real exchange rate of the dollar since 2001 — it has depreciated fairly sharply. But during the same period imports grew — even though the dollar's performance should have sent them in the other direction. (The difference between "real" and "nominal" exchange rates is important. Real rates take into account the diverging inflation rates of the two nations whose money is being exchanged. So when, say, an American travels to England, he needs to consider not only how many pounds he can buy with a dollar — the nominal exchange rate — but also which goods he can buy in England with those pounds.)

Exchange rates have long been one of the most difficult macroeconomic variables to model. As an important "price" in an economy — particularly "open" economies dependent on trade

— an exchange rate would seem likely to have a wide impact on any number of economic transactions, and thus have a strong connection with the underlying economy. In many economic models, monetary stimulus is supposed to raise domestic GDP while lowering the value of the home currency — an implied correlation between depreciations and business-cycle expansions.

The problem is that real-life data don't clearly show this relationship. This problem even has a name: the exchange rate disconnect puzzle.

Early Work

Credit for the discovery of the puzzle goes to economists Kenneth Rogoff and Richard Meese. In 1983, they demonstrated the complete lack of correlation between real exchange rates and other economic variables in developed countries. At the time, they were staff economists at the Federal Reserve Board of Governors charged with figuring out not only *why* exchange rates moved but also finding a way to forecast their movements. As Rogoff, now at Harvard, recounted in a 2002 essay, they produced a model aimed at answering this simple question: "We will tell you what money supplies, interest rates, and outputs are going to be one year hence. You have to predict the exchange rate."

They failed. But in failing, they sort of succeeded. What Rogoff and Meese had done was to make vividly clear that existing exchange rate models were largely useless. They discovered that a simple random-walk model — where

future rate movements have no relation to past movements — was as good or even a better predictor of exchange rates than the day's standard forecasting models. Rogoff and Meese concluded that there was no stable set of variables to explain exchange rates in any coherent way over 12- to 18-month horizons. And their conclusion has stood up over two decades and literally hundreds of studies. "Basically, the problem is not simply that it is virtually impossible to predict exchange rates," Rogoff wrote in an e-mail exchange for this story. "No variable, or set of variables, seems to explain them after the fact."

In the late 1980s, economists Alan Stockman and Marianne Baxter showed how the disconnect runs both ways. Just as Rogoff and Meese couldn't use macro-variables to explain exchange rate swings, Stockman and Baxter demonstrated that exchange rate volatility seems to have no major, systematic impact on macro-variables. Together with the Rogoff-Meese innovation, these remain the most important advances in understanding the exchange rate disconnect puzzle.

The puzzle can pose problems for policymakers. Without a clear understanding of how exchange rates relate to the economy, how are they to respond to currency volatility? In less-developed countries with immature capital markets, exchange rate volatility can cause significant harm to the economy. It can trigger the shifting of resources in a very dramatic way across sectors of the country in question.

But the case is different for well-developed countries: Should policymakers there worry about the wobbling values of their currencies? Or, looking at the disconnect data, should they simply conclude that getting overly exercised about exchange rates is a waste of time, given their lack of impact on the underlying economy? In particular, policymakers who worry about exchange rate movements have to weigh the relative merits of the two leading ways to manage their currencies — through fixed or floating systems.

Fixed Or Flexible?

The world's leading industrial nations began a movement to floating exchange rate regimes in the 1970s. It was at that time that the U.S. economic woes led to the devaluation of the dollar. Since so many other countries' currencies were pegged to the dollar under the Bretton Woods agreement of 1944, the dollar devaluation led to waning confidence in the system, and countries began to exit it wholesale.

Today, there is no clear consensus among economists on which is the best exchange rate regime. Flexible exchange rate systems are those in which governments do not intervene in foreign exchange markets to try to influence their currencies. This kind of system carries the virtue of letting the market determine currency values, which makes it more likely that a country's exchange rate bears close relation to underlying economic conditions. Additionally, a flexible regime allows monetary policy to be used on economic objectives other than influencing exchange rates — most importantly, price stability.

By contrast, countries that peg their exchange rate must concentrate "monetary policy" on manipulating the exchange rate. However, some economists believe that fixed rate systems — in which a government buys and sells its currency at the necessary amounts to keep its exchange rate pegged to some other currency — are more convenient, reduce information costs, and foster international trade by reducing volatility. Fixed systems are also more immediately

useful in controlling inflation. In fact, theoretically, fixed-exchange rate nations should have the same long-run inflation rates as the country they are pegging to, thanks to something called the "purchasing power parity theory." This theory, according to Stockman's *Introduction to Economics*, says that exchange rates change to equalize the prices of products in all countries over the long run.

The trade-offs inherent in each system are evident in the currency crisis that struck Argentina in 2002. Argentina had adopted a currency board regime — in which its peso was pegged to the dollar — in 1991 as a means, in part, to fight hyperinflation. It worked in that regard, immediately tamping down consumer prices. But in the mid-1990s, some of its South American neighbors and then several Asian countries saw their currencies decline rapidly. That made the peso, linked to the dollar, overvalued and in turn made Argentine exports more expensive. So in early 2002, Argentina abandoned the currency peg and let the peso devalue so that Argentine products would be cheaper. This led to another round of inflation and also had the negative side effect of hurting the investments of multinational firms that did business in Argentina.

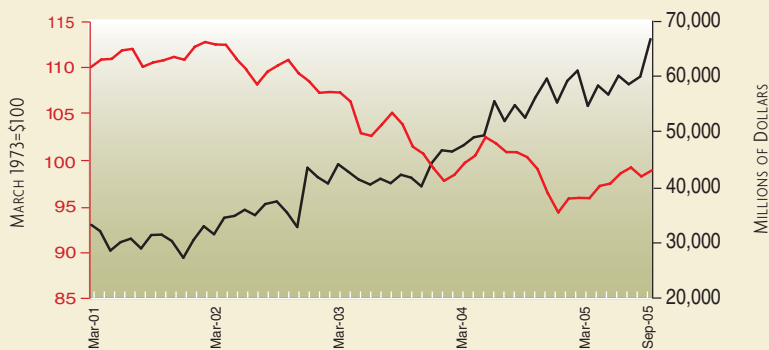
The Argentine experience is emblematic of the kinds of choices policymakers face in trying to handle

exchange rate movements. If their currencies are managed, should they intervene heavily in foreign exchange markets to keep them stable? If they are allowed to float, should the central bank — like the Fed in the United States — sometimes try to influence them through the use of monetary policy? The answers are elusive in large part because of the exchange rate disconnect puzzle and the inability of economists to produce models which would suggest clear paths for policymakers.

Over the years, scores of economists have tried to tackle the exchange rate disconnect puzzle. Some of the biggest progress came from the puzzle's pioneer, Rogoff himself. Just a few years ago, he teamed with economist Maurice Obstfeld in trying to explain why macroeconomic fundamentals are so out of whack with exchange rate movements. Their answer, in a 2000 paper, was basically that the economies of big, industrialized nations tend to be complicated. This means that markets are not fully integrated, so that price changes in one segment don't affect those in others. Together with sticky prices, this market segmentation can largely insulate consumers from exchange-rate swings. "Only gradually will the responses of importers and exporters feed through to the retail level," Obstfeld and Rogoff wrote.

The Exchange Rate and Foreign Trade

Despite the dollar's decline, the trade deficit has continued to rise.



NOTE: The red line represents the weighted average of the real foreign exchange values of the U.S. dollar against the currencies of a large group of major U.S. trading partners, and is plotted against the left Y-axis. The black line represents monthly data on the trade deficit, and is plotted against the right Y-axis. SOURCES: Federal Reserve Board of Governors and Bureau of Economic Analysis

Richmond Research

Margarida Duarte, an economist with the Richmond Fed and a former student of Stockman's at the University of Rochester, has focused much of her research on the exchange rate disconnect puzzle. In one recent paper, Duarte examines what happens when nations move from fixed to flexible exchange rate regimes, hoping therein to learn more about why exchange rates can be so volatile compared with other macroeconomic variables. In a second paper, she develops a model in which the complicated workings of financial markets play a significant role in explaining the exchange rate disconnect puzzle. In both cases, she builds on a sticky price model developed by Obstfeld and Rogoff in 1995.

In a paper published in the *Journal of Monetary Economics*, she presented a model that successfully replicated real-world results. It showed that "moving from pegged to floating rates generates a substantial increase in the volatility of the real exchange rate," but not in other variables. This was in keeping with the vexing data that the only distinction across exchange rate regimes is dramatic change in exchange rate volatility. The model, Duarte says, usefully explores the merits of different exchange rate regimes. It also advances the literature on why exchange rates are more unstable than other variables. But it doesn't get to the other side of the "disconnect" puzzle — what are the sources of uncertainty that generate substantial exchange rate instability (and which is not transmitted to other variables) but

no substantial instability in other macro-variables?

In a 2005 paper with Stockman, who is also a former visiting scholar at the Richmond Fed, the two aimed to answer that question more directly. Like past models, theirs sought to tie the determination of exchange rates to consumer decisions. The twist was to leave a role for the "asset-price" nature of exchange rates. By this, they intended to add a feature wherein exchange rates are a) affected by shocks to the financial markets and b) these shocks only show up in the financial markets, not in the underlying economy. The results looked much more like what happens in the real world. "Now I can generate a much higher volatility of nominal exchange rates without that implying high volatility of consumption allocations or high comovement across these two sets of variables," Duarte says.

Rogoff himself continues to study the problem and says that Duarte's and Stockman's joint efforts are "very promising for understanding some aspects of the disconnect puzzle." But all this still leaves plenty of room for improvement. Quantitatively, the Duarte-Stockman model is not an answer to why exchange rates are more volatile than other macro-variables. Having identified asset prices as one of the key variables in exchange rate movements, economists still haven't figured out a good way to model asset prices in keeping with their behavior in the real economy. A lot of it comes down to the complexities of drawing up coherent, consistent models that accurately resemble real-world data. It is difficult to write down

models that account for such things as idiosyncratic risk, for example. And the way foreign exchange markets are typically modeled may be too simplified.

A counter-explanation for the exchange rate disconnect puzzle: That some currency traders are inexperienced and thus behaving irrationally. It's true, Duarte says, that the model with "noise traders" of economists Michael Devereux and Charles Engel generates exchange rate swings that seem to have no correlation to economic fundamentals. But proving that there is a connection between irrational speculation and the exchange rate disconnect puzzle remains another matter. "Either model may 'explain' the data," Duarte and Stockman argue, "if only in the sense of labeling our ignorance, or might promote better understanding of the issues. But these kinds of success have limits: They do not imply that a model is appropriate for analyzing welfare, or policies."

Duarte says, "There's progress but it's slow. We need to model these economies in a more realistic way so that idiosyncratic risk matters more. That's where we are now."

Rogoff agrees that progress is being made. But he tends to think that his work of more than 20 years ago continues to hold important lessons for policymakers who "fret endlessly about exchange rate volatility."

He says: "The exchange rate disconnect puzzle suggests that, at least for countries with well-developed capital markets, perhaps they should take a more relaxed attitude." **RF**

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BASE CLOSURES

in the Fifth District

COMPILED BY MEGAN MARTORANA AND DOUG CAMPBELL

If you add up the numbers in the 2005 Base Realignment and Closure Commission's final report, things don't look good for the Fifth District. The commission estimates some 17,000 net jobs to be lost from Maryland down to South Carolina. That's even more than the nationwide net loss of 8,000 estimated jobs to be eliminated in the BRAC process.

But analysts strongly caution that the BRAC figures are preliminary and subject to change. While the bases targeted for realignment and closure are now virtually set in stone, the precise impact on direct employment remains in flux. For example, the final BRAC report estimated total job losses in Virginia at 18,770.

But that estimate comes with several caveats. The fate of the Naval Air Station in Oceana has not yet been settled, for one thing. Additionally, there has been no final determination yet where the jobs scuttled by the military's nearly wholesale exit from leased office space in Arlington and Alexandria will end up — many are likely to remain in the nearby metro Washington, D.C., area. Finally, there are potentially thousands of classified functions that may be transferred into Virginia.

"Virginia is not necessarily a big loser," says Dave Dickson, acting executive director for the Virginia National Defense Industry Authority. "We still have a lot of unknowns out there. All these military installations are dynamic communities, with people coming and going all the time. It drives the economists and accountants a little batty."

There was only one Fifth District base on the final report's list of 22 "major closures" — Fort Monroe in Virginia, which may result in the loss of 3,564 total direct jobs. Among the 33 nationwide "major realignments," which are where major job cuts are expected to happen, are Walter Reed National Military Medical Center in the District of Columbia, Fort Eustis in Virginia, the Naval Air Station in Oceana, Va., and Pope Air Force Base, NC.

All together, the 2005 BRAC round is intended to save U.S. taxpayers \$15 billion over 20 years. Job losses from base realignments inevitably cause economic damage to their local communities, but they are not insurmountable. Many bases, which often occupy prime real estate, are redeveloped for profitable use. Soon-to-be vacated office space in Arlington and Alexandria would seem likeliest for speedy redevelopment.

On the other hand, only two of the five major base redevelopments in the Fifth District since 1993 have produced enough new jobs from private-sector investment to restore the number of civilian jobs lost post-BRAC. In that regard, the Charleston Naval Complex in South Carolina still hasn't recovered fully from the 6,272 jobs lost in the 1993 BRAC process, gaining just 2,797 jobs in replacement since. (See "Redevelopment Boot Camp," *Region Focus*, Summer 2005.)

The Defense Department has until Sept. 15, 2007, to begin closing and realigning the installations and must be finished by Sept. 15, 2011.

Fifth District Highlights

(Note: All figures are estimates, with final impact depending on a wide variety of as-yet undetermined factors.)

District of Columbia

Total Direct Job Changes: 7,407 jobs lost
Biggest Impact: Realignment of Walter Reed Army Medical Center, 5,663 direct jobs lost

Maryland

Total Direct Job Changes: 8,900 jobs gained
Biggest Impacts: Addition of 5,361 total direct jobs at Fort Meade; Addition of 2,829 total direct jobs to the National Naval Medical Center in Bethesda

North Carolina

Total Direct Job Changes: 145 jobs lost
Biggest Impacts: Gain of 3,663 total direct jobs at Fort Bragg; Loss of 4,112 direct jobs with realignment of Pope Air Force Base

South Carolina

Total Direct Job Changes: 334 jobs gained
Biggest Impacts: Loss of 630 direct jobs with realignment of the Naval Weapons Station in Charleston; Gain of 615 total direct jobs at Fort Jackson

Virginia

Total Direct Job Changes: 18,770 jobs lost
Biggest Impacts: Loss of 11,173 total direct jobs at the Naval Air Station in Oceana; Loss of 18,750 jobs from various leased space in suburban Washington, D.C., area; Gain of 12,595 jobs at Fort Belvoir

West Virginia

Total Direct Job Changes: 105 jobs lost
Biggest Impact: Loss of 88 jobs at Fairmont U.S. Army National Guard Reserve Center

District of Columbia

- 1. Bolling Air Force Base
- 2. Naval District Washington
- 3. Potomac Annex
- 4. Walter Reed Army Medical Center

Northern Virginia

- 5. DFAS Arlington
- 6. Marine Corps Advanced Amphibious Assault
- 7. Fort Belvoir
- 8. Marine Corps Base Quantico
- 9. Naval Surface Warfare Center Dahlgren
- 10. Arlington Service Center
- 11. Headquarters Battalion
Headquarters Marine Corps Henderson Hall
- 12. Various Leased Space

Maryland

- 15. Fort Meade
- 16. Naval Station Annapolis
- 17. Army Research Laboratory Adelphi
- 18. Naval Surface Warfare Center Indian Head
- 19. Andrews Air Force Base
- 20. Naval Air Facility Washington
- 21. Martin State Airport Air Guard Station
- 22. Fort Detrick
- 23. Navy Reserve Center Adelphi
- 24. National Naval Medical Center Bethesda
- 25. Naval Surface Weapons Station Carderock
- 26. Aberdeen Proving Ground
- 27. Defense Finance and Accounting Service Patuxent River
- 28. Naval Air Station Patuxent River
- 29. PFC Flair U.S. Army Reserve Center Frederick

West Virginia

- 13. Fairmont U.S. Army National Guard Reserve Center
- 14. Bias U.S. Army Reserve Center Huntington

Central and Southeastern Virginia

- 30. Richmond International Airport Air Guard Station
- 31. Defense Supply Center Richmond
- 32. Naval Weapons Station Yorktown
- 33. Fort Lee
- 34. Fort Eustis
- 35. Langley Air Force Base
- 36. Fort Monroe
- 37. Naval Amphibious Base Little Creek
- 38. Naval Support Activity Norfolk
- 39. Naval Medical Center Portsmouth
- 40. Naval Shipyard Norfolk
- 41. Naval Station Norfolk
- 42. Naval Air Station Oceana

North Carolina

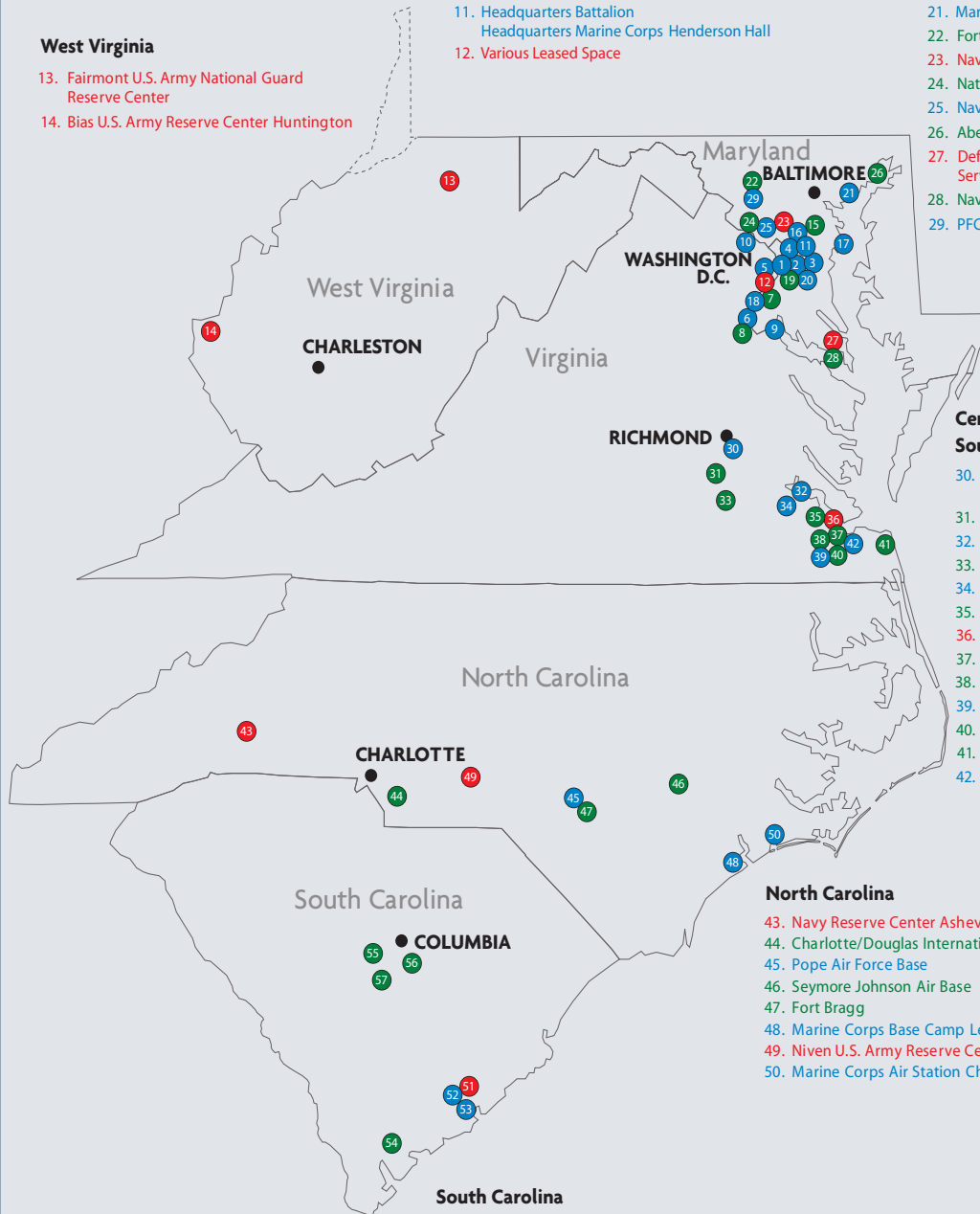
- 43. Navy Reserve Center Asheville
- 44. Charlotte/Douglas International Airport
- 45. Pope Air Force Base
- 46. Seymour Johnson Air Base
- 47. Fort Bragg
- 48. Marine Corps Base Camp Lejeune
- 49. Niven U.S. Army Reserve Center Albermarle
- 50. Marine Corps Air Station Cherry Point

South Carolina

- 51. Defense Finance and Accounting Service Charleston
- 52. Naval Weapons Station Charleston
- 53. South Naval Facilities Engineering Command
- 54. Marine Corps Air Station Beaufort
- 55. Fort Jackson
- 56. Shaw Air Force Base
- 57. McEntire Air Guard Station

Legend

- Closure
- Realignment
- Gaining jobs



SOURCE: 2005 Defense Base Realignment and Closure Commission Final Report



THE SHEEPSKIN DIVIDEND

A college degree is still the best predictor of financial success, but that's not all

BY BETTY JOYCE NASH

When Debbie Barr was a high school senior in Sophia, W.Va., she happened to bump into a college recruiter at lunch. Barr wanted very much to go to college, but her father had been injured in a mining accident, and her family's income was next to nothing. She'd written off the idea.

Although Barr was an "A" student, her high school counselor had never mentioned college. "The girls got married and had kids," Barr recalls. "And this was the 1980s." Her chance meeting with a Concord College representative proved fruitful, and Barr slogged through intimidating financial aid forms. She earned her bachelor's degree in English Education from Concord, located in Athens, W.Va.

"I'm trying to push my niece and cousins [to go to college] because it is important," she says. "Wal-Mart can't support you all your life."

Today, Barr is the lead counselor for West Virginia's Talent Search, a federally funded effort produced by the Higher Education Act of 1965. The idea is to identify low-income sixth-graders and track them through high school, making sure they build skills and take college prep classes. Along the way, the counselors help with inspiration, study habits, financial aid forms, and field trips.

To forgo college is a costly choice,

despite rising tuition. A college education is pulling in a higher premium than ever to workers' paychecks. Graduates with a four-year degree not only make more money than nongraduates — 62 percent more in 2003 and 73 percent more over a working life of 40 years — but they're also more likely to volunteer, give blood, use a library, and open retirement accounts than nongraduates. They're healthier (less than 15 percent smoke) and (by some measures) make better parents.

Economists continue to study the effects of going to college, just one institution through which "human capital" is nurtured. They aim to figure out how public resources ought to be directed at helping more young people enter and finish college.

Education's Black Box

While more people may be going to college than ever before, completion rates have stagnated. A recent study by the Higher Education Research Institute at the University of California at Los Angeles reports that among freshmen who entered four-year colleges in fall 1994, 36.4 percent completed a degree within four years, compared to 39.9 percent 10 years earlier and 46.7 percent in the late 1960s. The rate of completion rises after six years to 61.6 percent.

And income matters. Among poor students, an estimated 7 percent earn a

bachelor's degree by the age of 24 compared with 39 percent from the middle-income group and 52 percent from those with the highest income.

Usually, people balance the money they'll spend on college with the time in forgone earnings and add up what they'll gain by earning a degree. A special report published by the College Board, "Education Pays," found that by the time a graduate is 33, he has earned enough to make up for tuition and forgone earnings, if he entered a public, four-year college at age 18.

Some benefits of postsecondary education are less quantifiable. For example, economists Janet Currie and Enrico Moretti found that higher maternal education improves infant health: "Our results add to the growing body of literature which suggests that estimates of the returns to education which focus only on increases in wages understate the total return."

But the earnings signal is loud and clear. In 1979, people with a bachelor's degree or higher earned about 45 percent more per hour than high school graduates — and that difference has risen over time. In 2003, the average full-time worker in the United States with a four-year degree earned \$49,900 compared with \$30,800 earned by a high school graduate, about 62 percent more. Those with master's degrees earned nearly twice as much, \$59,500, and medicine and law

graduates earned almost three times as much, \$95,700, according to "Education Pays."

Understanding the relationship between money and education is central to policy discussions. The question has prompted economists to ask whether education is responsible for the added value or whether it's a product of the smart, motivated people (who grew up in middle- and upper-income families that make early and continual investments in education) who typically finish college and make more money.

The Economic Keystone

Amber Godfrey, a senior at Virginia Commonwealth University, is the first in her family to attend college. Her parents, who joined the military to get the training they needed, have encouraged her since she was very young. "I have a lot more opportunities having my degree," she says. "I just know that's what we have to do the way our world is changing. The minimum requirement is becoming, 'Do you have a bachelor's?'" Godfrey, a former high school basketball player and "people person," hopes to work in sports and entertainment as a public relations specialist. She just made the cut as a finalist for an internship with the National Basketball Association.

College graduates have better outcomes all the way around. But it's hard to break inside the black box to figure out why. Sarah Turner, an economist at the University of Virginia, asks whether that's caused by college per se. The answer is complicated. "But there certainly remains a robust premium for the types of general skills that come out of a college education."

The hurdles are financial as well as academic. "Now more than ever if you are a low-performing, high-income kid, your odds of going to college are extraordinarily high," Turner notes. Minority students are likely to have fewer resources, and financial aid simply hasn't kept up with growth in tuition, according to Donald Heller of Pennsylvania State University's Center for the Study of Higher Education. He

spells out the problem: Poor and minority students go to poorer schools, receive less in the way of academic preparation, and often have no one to propel them toward college. "Since they don't have the experience, they don't know how to take the steps to go to college, how to take the tests, which math courses to take — a whole slew of things, the advantages that largely white middle class has," he says.

What a drag. On the economy.

Economic research shows that education contributes to productivity, adds to personal earnings, and leads to efficiency. People can adjust to change in the workplace more quickly, among other benefits. But sluggish educational attainment spells trouble. "Slower growth of the educational attainment of the workforce directly reduces economic growth by slowing growth in labor force 'quality' and may have an adverse impact on the rate of technological advance," writes Harvard economist Larry Katz.

The connection between economic performance and education is strong. For example, the U.S. Census Bureau reports Maryland's percentage of the population with a bachelor's degree at 35 percent, more than 8 percent higher than a decade ago. During the same period, total personal income in Maryland rose by 13 percent, according to the National Center for Public Policy and Higher Education. And in South Carolina, where nearly 25 percent of the over-age-25 population has a bachelor's degree, the state's per-capita income is \$27,153, about 82 percent of the national average of \$33,041 — 44th in the nation. In West Virginia, 15.3 percent of people over 25 have degrees and per-capita income is \$25,681 — 50th among states.

If a region is looking to build a solid economic base, then knowledge is the cornerstone.

Even with rising tuition levels, college is still a good deal, according to Lisa Barrow and Cecilia Rouse, authors of the 2005 article "Does College Still Pay?" published in *The Economists' Voice*. Even though there

are more college graduates — the share of the population with bachelor's degrees went from 26 percent in 1996 to 30 percent in 2004 — they continue to earn more money, indicating increased demand. But average wages of lower-skilled workers have gone up recently too. The authors conclude that the economic boom of the late 1990s explains the rise in average wages of all workers. Despite that and the hefty increases in tuition, the payoff from getting a college degree continues to outstrip the ever-mounting costs.

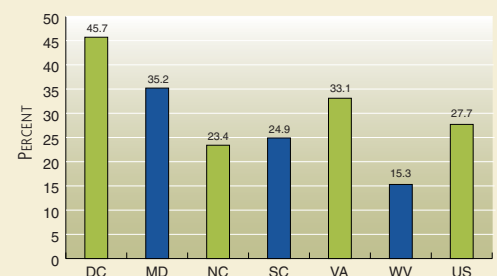
The authors calculated the cost of an education this way: Take four years of tuition and fees at a typical university and then add four years of lost wages, using average annual earnings of a high school graduate. That amounted to about \$107,277. According to the study, the lifetime boost to wages of a college degree is about \$403,000. Subtract the cost of college and still wind up with a benefit of nearly \$300,000.

What's good for the labor market is good for the economy. And today's labor market requires higher-level skills, says Penn State's Heller.

"We used to talk about the middle-class lifestyle," he says. "You could go off and get a union job and live that lifestyle, but more and more those jobs aren't here anymore. People are requiring more training to live that lifestyle."

Population with a College Degree

The connection between education and economic performance is strong.



NOTE: Data are for 2004. Percent of population 25 years or older with a bachelor's degree or higher.
SOURCES: U.S. Census Bureau and *Postsecondary Education Opportunity*

Barriers to Entry

Many high schools, especially rural and inner city, just don't groom students for college. Stanford University's Bridge Project found that state high school tests often focus on different knowledge and skills than college entrance and placement requirements, leaving students in the lurch academically. Guidance counselors are overworked by state test requirements, often irrelevant to college preparation.

An even bigger problem is that rising college costs have left some students priced out of the market. The problem is, naturally, worse for low-income kids, arguably the group needing education the most. And if they do start, they are unlikely to finish.

"It's true that more low-income students enroll in college now than in the 1970s — but they are less likely to graduate than their wealthier peers," writes Ross Douthat in "Does Meritocracy Work?" in the November 2005 *Atlantic Monthly*. Fifty-five percent of need-based Pell Grant recipients, for example, attended two-year rather than four-year schools in 2002, compared to 38 percent in 1974.

A 2002 report of the independent Advisory Committee on Student Financial Assistance, which counsels Congress and the U.S. Secretary of Education, found that nearly half of qualified high school graduates from poor and moderate-income families in 2002 did not enter four-year colleges within two years of graduation and 22 percent, 170,000, did not go to college at all.

The report, "Empty Promises: The Myth of College Access in America," places the number of students who are qualified but can't attend four-year schools for financial reasons at 400,000. That number isn't trivial, says Heller, who worked on the report.

"We know in certain regions, in certain labor markets, there are shortages," Heller says. "If we were able to get these students, we'd be able to have much more flexibility in labor markets to ensure we've got enough to meet demand of the work force."

Moving the Mountain

Among Fifth District states, the percentage of college graduates varies widely, with West Virginia's 15.3 percent the lowest. The Mountain State's low percentage of graduates makes Debbie Barr's protégés at Talent Search a primo resource. (West Virginia's population is aging with few moving in. According to the U.S. Census Bureau, by 2025, there will be nearly 19 percent fewer traditional college-age students in the state, the biggest decline in the nation.)

Educators in the state are working hard to send students to college. About 70 percent of West Virginia's Talent Search seniors enroll in college, according to state coordinator Bob Long of the West Virginia Higher Education Policy Commission. The search reaches students with family incomes of less than \$12,000 in 74 schools in 55 counties.

"Historically, all the studies and all the data show even the bright kids of low income do not go to college at the same rates as intelligent kids from more affluent backgrounds," Long says.

West Virginia aims to improve its college matriculation rate partly by developing relationships between each stage of schooling: elementary, middle, and secondary. The state jacked up the levels of science and math classes so students enter college prepared to take college-level courses without spending half a year in remedial classes.

In 2004, West Virginia was rated as a top-performing state in the proportions of high school students enrolled in upper-level math, 59 percent, and science, 44 percent, according to "Measuring Up 2004," a report by the National Center for Public Policy and Higher Education. The state's Promise scholarships, funded by lottery proceeds, reward students who maintain a 3.0 average and score 21 or above on the ACT.

They're seeing results. Since 1996, college matriculation rates of West Virginia high school graduates has risen from about 47 percent to 59.4

percent, exceeding the national average of 56.7 percent.

"We're starting to do a good job at the front end, now we have to focus on the back end, which is retention," Long says. "Student services, including intervention once students get on campus, with mentors, is the other end of the pendulum."

Lifelong Learning

Many students never make it to four-year schools. In the 1960s and 1970s, in an effort to "democratize" higher education, public policies expanded community colleges.

"That did more to access in higher education than any other movement over the last 100 years," Heller says. The community colleges opened doors especially for minorities and women. Women today comprise 57 percent of all college students, and 58 percent of community college students.

Nearly half, about 46 percent, of undergraduates attend community colleges, where the average age is 29. Community colleges were designed to give students the first two years of basic studies, after which they'd transfer to a four-year school to complete a degree. Ultimately, the mission expanded to vocational training.

Typically, community college students are the first in their families to attend college. While community colleges clearly play a role in human capital accumulation, the student retention rates can't match those of four-year schools.

In a paper published in 1999 in the *Journal of Economic Perspectives*, Thomas Kane and Cecilia Rouse found that of all students enrolling in two-year colleges, more than half don't complete any degrees, about 15 percent earn a certificate, another 16 percent obtain an associate's degree, and about 16 percent complete a bachelor's degree. At four-year colleges, nearly 60 percent complete bachelor's degrees.

The community colleges can respond quickly to demand, though, especially in economic downturns.

And an associate's degree holder in 2003 earned \$37,600 compared to the \$30,800 earned by a high school graduate. Enrollment increased at community colleges by about 5 percent between 1990 and 2004 as tuition at four-year schools rose.

Overall, today more older students attend postsecondary institutions than traditional-age college students, according to Sondra Stallard, a professor and dean of the School of Continuing and Professional Studies at the University of Virginia.

"We've had students who left because they need to work part-time so they don't incur so much debt," Stallard says. She notes that students can begin at Piedmont Virginia Community College and transfer to the University of Virginia for a lot less money. The students in the program typically work full-time.

Shelley Tattersall is 42. She had attended a New Jersey community college in her 20s, but never finished. She now works at the University of Virginia in administration and needed education to advance. "I wanted more challenging work and a degree would give me more options," she says.

What to Do?

While the educational premium seems irrefutable and the argument that economic growth depends on capital, physical and human, remains strong, policy experts differ on the best way to ramp up educational attainment.

About 14 states are giving students merit scholarships. The idea is to nurture human capital and encourage students to stay in their home states after graduation from high school and

hopefully even after college. Eligibility criteria vary from state to state and include minimum grade point averages and standardized test scores. In the Fifth District, South Carolina and West Virginia offer merit scholarships.

Problematically, those awards typically go to higher-income students who would have gone to college anyway. Also, state merit scholarships can help with rising tuition costs, but can't compensate for poor early schooling, a ragged home life, or rock bottom confidence.

Debbie Barr has been there. She remembers her fears: "Could I make it? What if I get down here and mess up?"

She did make it through, and her case illustrates the myriad benefits of an education. "It's opened up doors for me to give back to my community." **RF**

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Bottleneck

What the Fifth District's only major oil refinery explains about high gas prices in the wake of Hurricanes Katrina and Rita BY DOUG CAMPBELL

If you want to understand why gas prices shot up past \$3 a gallon immediately after Hurricane Katrina hit the Gulf Coast, consider looking at Virginia's sole oil refinery — in fact, the only refinery of any significance in the Fifth District. Almost everything you need to know about gas prices can be explained, at least indirectly, with a visit to Giant Industries' refinery in Yorktown, Va.

The 570-acre facility is dotted by mammoth storage tanks, soaring distillation towers, and miles of pipes. The plant churns out upward of 60,000 oil barrels a day, which may sound like a lot but is actually just a drop in the national bucket of refinery capacity; in fact, it is less than a half percent of the total U.S. daily refinery output. If the Yorktown refinery was shut down — as it temporarily was in 2003 with Hurricane Isabel and then again this fall after a fire — national gas prices wouldn't even blip. But the way Yorktown operated in the aftermath of Katrina provides a vivid picture of how price changes are a function of economic rules about supply and demand,

regulation, and competitive markets.

“Whoever has control of a resource that suddenly becomes scarce — in this case, refinery capacity — those people will experience a substantial increase in profits,” says Stephen Brown, director of energy economics at the Federal Reserve Bank of Dallas. “This is a normal market phenomenon, much the same as owning a piece of land that suddenly becomes valuable.”

Of course, there are other things going on as well. Oil prices, as the Energy Information Administration points out, “are a result of thousands of transactions taking place simultaneously around the world, at all levels of the distribution chain from crude oil producer to individual consumer.” At the same time, the hub of much of this interaction takes place at refineries like the one at the mouth of the York River.


The Refining Process

Yorktown is about 10 miles southeast of Williamsburg. Giant Industries Inc. bought the 1954-built refinery in 2002 from BP p.l.c. for about \$170 million.

The site employs about 300 workers, including contractors. Much of the area is under construction as the refinery is upgraded to meet new clean fuel laws. Charley Yonker, vice president of administrative services with Giant in Yorktown, says the cost of the improvements is almost equal to the plant's acquisition price three years ago.

The Yorktown facility receives ships loaded with crude oil from around the world but lately has gotten a lot of North Sea traffic. After arriving in Yorktown, crude oil is pumped from the ships via pipes to storage tanks. There it waits just hours or a few days until going through a de-salting process and then being “charged to the unit,” or moved into distillation towers.

These towers — there are 20 of them on the Yorktown site — are where the main refining process happens. Refining crude oil is all about heating and cooling, pressuring and depressuring to separate crude oil's main chemical components — gasolines, diesels, greases, and asphalts. When it enters the tower, crude oil is heated to upward of



Giant Industries owns and operates Virginia's only oil refinery, which sits on 570 acres and churns out about 60,000 barrels a day.

800 degrees Fahrenheit, causing it to vaporize. As the vapor rises along the tower's 10-or-so stories, it condenses and collects at different vertical points. Gasoline components, for example, are lighter in molecular weight and rise high in the tower before condensing. Catalysts can be added in the process as well to promote certain chemical reactions. The resulting products are pulled off the tower via pipes at ascending heights. The parts that don't vaporize make tar and asphalt. The whole process can take as little as eight hours.

Yorktown makes three grades of gasoline, two grades of diesel, kerosene, fuel oil, propane, and coke (a high-carbon residue that can be used as a boiler fuel to make steam or electric power). Giant Industries sells to a wide variety of fuel companies, ranging from major oil brands to independents like convenience store chain Royal Farms, which is based in Baltimore.

For gas products, Yorktown sends out most of its output via barges that dock at its pier and usually head north to New Jersey. There, the gas is pumped into storage tanks where the gas firms add the final additives before trucking them to the pumps. A smaller portion of Yorktown's gas is picked up by trucks, whose travel radius is about 150 miles. Additives in this case are added on-site.

Maxed Out

Yorktown is running at maximum output almost every day. That is why this summer's hurricanes made such a sizable — and positive — impact on Giant Industries' bottom line.

For a short time, Hurricanes Katrina and Rita knocked out many refineries in the Gulf Coast, cutting the nation's refining capacity by about 25 percent. Even well into October about 18 percent of U.S. refining capacity remained idle because of the storms. So even though the United States opened its strategic oil reserve, easing the shortage of crude oil, there remained a shortage of refinery capacity. That's where the bottleneck happened. Meanwhile, demand for gas remained relatively stable. From there, all you need is to look at a simple chart of supply and demand to see why prices rose as quantity dropped.

The Yorktown refinery dealt with the supply disruption by allocating products to its customers based on their average "lifting" levels over the past six months. Instead of being able to collect a full order, customers took 80 percent or so.

The storms hurt refinery capacity more than production capacity. Which means there was crude oil ready to be refined — but with no place to go. If there was more refinery capacity in the United States, the price hikes might not have been so steep. Although existing refineries have expanded in recent years, there has been no new refinery built in the United States since 1976. In addition, some have shut their doors. There were 324 refineries in 1981 but just 144 today. Over the same time, the volume of crude oil refined in this nation has also dropped from 18.6 million to 16.9 million barrels. Meanwhile, demand has grown about 25 percent over the past two decades.

Refinery companies blame environmental regulations. "A lot have

decided not to stay in the business. It's very capital intensive," says Leroy Crow, chief of refinery operations at Giant. "We spend \$80 [million] to \$90 million in 2005 at our refineries [on mandated upgrades] and those improvements have no payback, no return on investment."

The Yorktown refinery's relative isolation illustrates the capacity problem. Building new refineries requires hard-to-find qualities like vast acreage, port access, and ample water and power supplies, not to mention compliance with increasing environmental rules. With Yorktown as the only refinery in the Mid-Atlantic, the gas supply problem was particularly acute in this region. For a time after Katrina, Baltimore endured the highest gas prices in the nation because the Colonial Pipeline running up and down the Mid-Atlantic was virtually dry when four major Gulf refineries serving it were shut down with the storm. And when new crude began hitting the East Coast, it went first to New York ports.

Brown, at the Dallas Fed, said it would take sustained prices of more than \$2.50 a gallon at the pump to make building a new refinery profitable under current regulations. Even then, it takes at least five years to go through a permitting process. That sharply limits the number of possible new entrants.

Price Gouging?

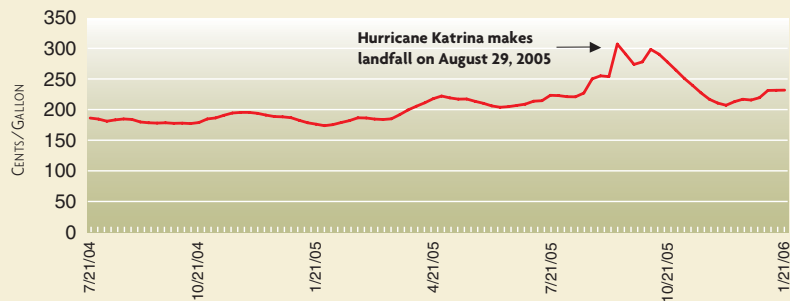
Stock in Giant shot up 45 percent in the wake of Hurricane Katrina. Net earnings jumped from \$6 million in the third quarter of 2004 to \$46.6 million in the same 2005 period. Jacques Rousseau, oil industry analyst

PHOTOGRAPHY: GIANT INDUSTRIES



Lower-Atlantic Gas Prices

Prices spiked following the hurricanes, but then moved back to pre-storm levels.



NOTE: The Lower Atlantic region: Florida, Georgia, South Carolina, North Carolina, Virginia, and West Virginia. Maryland and the District of Columbia are considered part of the Central Atlantic region.
SOURCE: Energy Information Administration

at Friedman Billings Ramsey in Arlington, Va., uniformly raised stock price estimates on the companies he follows after the hurricanes and predicted that the impact would be long term. "It is important to keep in mind that the hurricane's impact on inventories should have a long-lasting effect, and refiners are likely to have difficulty replenishing gasoline and distillate stocks in 2006," Rousseau wrote in a note to investors. He also cited refinery downtime for regulatory upgrades and removal of the controversial component MTBE from the gasoline pool as factors that will continue to dampen supply.

Oil companies like Giant are unapologetic about the windfall, describing it is part of the up and down industry cycle. "This works both ways," Crow says. "In 2002, you couldn't give gasoline away. The market is what the market will be."

Downstream

About 44 percent of the price of gasoline is determined by the price of

crude oil. The next highest portion of gas prices comes in the form of federal and state taxes, about 27 cents of every dollar. Refining accounts for roughly 15 percent. And the smallest portion, about 14 percent, is for the so-called "downstream" activities of marketing and distribution. Baltimore-based Royal Farms is a typical midsize gas retailer. But unlike big oil companies that have their own refining operations, retailers like Royal Farms were largely left out of the Katrina bonus. In general, the wholesale cost of fuel increased faster than retail prices. The supply disruption drove prices up at the pump in large part because retailers like Royal Farms paid higher prices for their wholesale products to ensure they had enough for their customers, and enough to pay for "future, more expensive gasoline deliveries," says the American Petroleum Institute, an industry trade group.

An economist would put it this way: Even if the retailer bought gas at \$2 a gallon today, if he knows that he will be buying it at \$3 a gallon in the

near future, then it behooves him to raise prices. In this way, he replaces inventory in a cost-effective manner. Meanwhile, the higher price signals that the resource is growing scarce and dampens demand. In any case, retailers ended up with no profit advantage because of the hurricanes, industry participants say.

"If anything, we did worse than a normal year," says Rob Rinehart, chief of gas operations at Royal Farms. Rinehart notes that the states of Delaware and Maryland, among others, are subpoenaing records of convenience retailers. "I believe they will find cries of price gouging to be unfounded in the retail sector," he says.

But that didn't stop lawmakers in Washington from holding hearings to question oil company executives about their post-hurricane profits. With consumers complaining about spiking gas prices, politicians responded by proposing taxes on oil firm "windfall profits" and warned against what they termed "price gouging."

It is true that many oil firms profited handsomely in the wake of the hurricanes. Whether that's something that should be legislated away, though, is not so obvious. Many energy economists believe the market should be largely left alone.

"I guess there's a political definition [of price gouging] — that if the change in prices is high enough that constituents call and complain," Brown says. "But as an economist, I have a hard time defining what price gouging is. Prices are signals that there's scarcity. They tell people to be using less gas." **RF**

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IDENTITY THEFT



Greater credit options have increased consumers' financial flexibility — and the ability of criminals to steal information. Still, the share of people victimized remains small

BY BETTY JOYCE NASH

When Lisa Cook of Columbia, S.C., tried to open her first checking account, somebody had already beat her to it, using her Social Security Number but a different name.

"It was \$600-some in the red," Cook says. That was the first of about \$98,000 in debt amassed under her Social Security Number. Cook, who is 26, was one of 2,148 people in South Carolina reporting identity theft to the Federal Trade Commission in 2004, roughly a third of them between the ages of 18 and 29.

After more than a year of fending off bill collectors, navigating voice-mail mazes for credit reports, making investigative trips to the imposter's town, copying fees, frustration, and

heartache, Cook is repairing her financial records.

"I was building my own credit," says Cook. "My mom told me if you don't have credit, you don't have anything." The imposter was eventually caught, charged, and imprisoned.

Assimilation of personal data has been a useful tool in allocating credit — let's face it, your Social Security Number is recorded and used as an identifier by everyone from doctor to landlord to employer. The data are a prime target for resellers as well as thieves, and have become relatively easy to mine.

Between electronic records and the ubiquity of credit cards, it's not so shocking that financial crimes would blossom. And for the fifth year in a row,

identity theft was at the top of the FTC's fraud complaint list. But what is identity theft? Does it include plain old credit card thievery? If so, survey data indicate that there were about 10 million victims in 2003. Or is it something larger — like using a person's Social Security Number to establish new accounts?

The challenge facing financial institutions and regulators alike is finding the proper balance between protecting consumers and making credit readily available. Nobody wants to hamper the efficient credit market that the free flow of data has created. But as online transactions and services grow, consumers, banks, and regulators are paying closer attention to identity theft and the mounting cost of

PHOTOGRAPHY: GETTY IMAGES

LEGISLATIVE AND REGULATORY ACTION

The Identity Theft and Assumption Deterrence Act of 1998

- Makes ID theft a federal crime with penalties of up to 15 years and a maximum fine of \$250,000
- Establishes victim status so he can seek restitution if there is a conviction
- Establishes the Federal Trade Commission as the central agency to collect complaints, referrals, and resources

Gramm-Leach-Bliley Act of 1999

- Requires financial institutions to protect information collected about individuals
- Requires financial institutions to give consumers privacy notices that explain the institutions' information-sharing practices
- Gives consumers the right to limit some information sharing

Fair and Accurate Credit Transactions Act of 2003

- Requires account numbers on credit card receipts be truncated to prevent confiscation of names and numbers
- Requires major credit-reporting agencies to provide consumers with a free copy of credit report annually
- Permits victims of ID theft to place an "alert" on credit files
- Rule making in progress

SOURCES: Federal Trade Commission and Privacy Rights Clearinghouse

preventing it. The crime has spawned its own industry of solutions and consultants, including identity theft insurance.

The Costs of ID Theft

Overall, identity theft cost businesses and financial institutions \$52.6 billion in 2004, according to a Javelin Strategy and Research survey. And that's just money lost; that doesn't count the complex systems put in place to fight it. Javelin is a consulting firm for the financial services and payments industry. The survey, similar in methodology to the FTC's 2003 Identity Theft Survey Report, was sponsored by financial services firms, including Visa USA and Wells Fargo Bank. The survey polled 4,000 people, including 507 fraud victims.

It's important to distinguish between credit card fraud and true identity theft, cautions John Hall, a spokesman with the American Bankers Association. "It's the difference between crime and murder," he says. "You don't just lump them together."

Fraud involving general-purpose credit cards averages less than 0.06 percent of sales today, thanks to sophisticated detection and monitoring. Merchants who do business online report decreases in lost revenue from payment fraud, from 3.6 percent in 2000 to 1.8 percent in 2004. Federal law limits consumer liability to \$50 per card.

Account takeover or new account fraud, like Lisa Cook's, is more troubling and a major hassle for the victim. Thieves steal what's in the account and use a creditworthy identity to get more; often their victims are relatives. Not always, though. Lisa Cook's imposter was as different from Lisa as night is from day — in sex, race, age, and residence. He was able to get credit at stores where she was not. And he bought two cars, got a business license, and several loans from payday lenders.

Credit Where Credit Is Due

Economists view credit favorably. It gives people greater financial choices and allows them to "smooth" their con-

sumption patterns over time. The growth in affordable, available credit stems largely from the flow of personal data in the national credit reporting system. The information provides lenders with many pieces to evaluate who gets credit and who doesn't and, most importantly, to reduce uncertainty and price the credit according to risk. Economists William Roberds of the Federal Reserve Bank of Atlanta and Charles Kahn of the University of Illinois have studied credit and identity theft and recently published a working paper about it.

"Any successful payment system, credit card ... cash or whatever has to have some way of tying the person in the transaction to somebody's records," Roberds says in an interview.

While instances of identity theft enrage consumers, no doubt about it, regulators are thinking long and hard before imposing strict rules on the data-gathering activities. According to Roberds and Kahn: "This reluctance stems, in part, from the notion that the collection of personal data is essential to the process of allocating credit."

Society may ultimately have to decide on a rate of identity theft that balances its preference for privacy with its tolerance for transaction fraud, the authors say.

"The take we have on credit card fraud, identity theft, is that it's sort of the byproduct of something good," Roberds says. "The something good is the fact that credit cards and debit cards and other types of payment systems have a good feature, allowing merchants to share identifying information on you."

By virtue of the fact that you have a credit card, your credit record is tied to you and allows you to engage in transactions you otherwise might not — that's the good side. "But the bad side is, once a mistake is made, once somebody gets a hold of your credit card number and uses it to tie you to transactions that they're involved in, that's a down side of that system," Roberds says.

Roberds and Kohn created a model that showed the upside outweighs the downside. "That's pretty much the way

it's worked out in the real world," Roberds says. "We worry about identity theft, but we don't want to give up our credit and debit cards."

The model indicates that in an economy where information is shared and there are more buyers, there is also more provision of credit. "People would be generally better off than in an economy where you didn't have this information sharing," he notes.

Credit has lowered the cost to merchants to do business on credit and likewise cut the cost to them of providing credit to customers. "It's expanded the set of transactions that can be done on credit," he says. "But the downside is we have these two prevalent types of fraud that have to be kept in check."

The Buck Stops Here

Worrisome data losses in 2005 among businesses, including several banks and data firms, set off a wave of publicity that raised questions about the security of personal data. Charlotte-based Bank of America lost a backup tape with information on 1.2 million accounts, and Bank of America and Wachovia, among other institutions, also lost data through dishonest insiders, according to Privacy Rights Clearinghouse, which maintains a list of data breaches.

Bank of America and Wachovia say they notify customers if data have been compromised. Among Fifth District states, North Carolina alone requires notification in case of data breaches, as of Dec. 1, 2005.

While the losses are undesirable, Julie Davis, spokeswoman for Bank of America, says that as far as the bank knows, none of the information has been used. "So while the tapes were lost, it really was a case of lost tapes and not stolen data."

The banking industry has come a long way since about 2000 when banks were afraid to "even mention the words 'identity theft,'" according to Ariana-Michele Moore, a senior analyst at Celent, a financial services consulting firm. Banks today

are educating consumers and employees, monitoring transactions, and using complex and expensive software systems to pick up the latest cyber scams. They sometimes offer free services to identity theft victims, such as account monitoring.

But they can't reveal all their tactics, says Nessa Feddis, senior federal counsel at the American Bankers Association. "The banks do a lot more than what we can say," Feddis says. After all, they don't want to publish a road map for criminals.

Steve Scott, Wachovia's director of corporate information security, says that when credit card numbers get exposed somehow online, "not only do we have to deal with the fraudulent activity that comes with those cards but we also have to deal with the customer."

While banks can't discuss nuts and bolts of preventive strategies, they've ramped up responses as the threats have escalated. Those include everything from the simplest and cheapest consumer and employee education to thorough investigation of partners.

Wachovia sends teams to supplier sites to review security. "Then we measure that against our own standards and requirements," Scott says. "If there are gaps, then we work with those vendors to close that gap and those could be deal breakers."

Scott won't say how big a problem identity theft is at Wachovia. "We all know it's a problem and we've had to rise to meet that... the identity theft creates more work for us." In general, he says, "there's a lot more energy being put around knowing the customer, a lot more process being put in place to make sure we have valid identification." A delicate balance exists between security and convenience. "Customers still want services that are dependable, available, secure, and easy to use," Scott says. Sometimes that's a hard combination. Customer acceptance and usability are the biggest drivers.

The Federal Financial Institutions Examination Council, comprised of representatives from five agencies

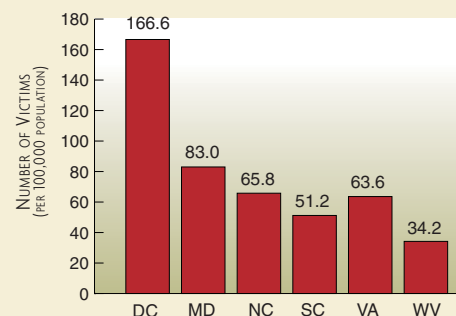
including the Federal Reserve, has told banks by the end of 2006 to complete a risk assessment and implement any technology necessary for added security, including customer authentication, verification of new customers, monitoring, and reporting.

"We, like the other financial institutions, are going through that assessment activity as we speak," Wachovia's Scott says. "Based on that, we'll use that information to apply the appropriate controls to where we think it needs to be best implemented." He would not say how much the extra actions would cost.

Bank of America, with the biggest pool of online customers nationwide, about 14 million, in 2005 introduced SiteKey. Spokeswoman Davis says it had been in the works for two years. SiteKey customers choose from among thousands of images and then create a phrase unique to them. They also select from a list of challenge questions. When logging on, customers look for the icon and phrase to pop up and then enter a password. "If you're at another computer, it asks you a challenge question," Davis explains. "The bank validates you before you log on. It lets the customer know they have indeed reached Bank of America." Even if an ID and pass code have been stolen through spyware (malicious software that can take over certain computer operations without the user's knowl-

Identity Theft Victims By State

The District of Columbia's rate of identity theft is the highest in the nation. Credit card fraud, at 28 percent of all cases nationwide, is the most common form of reported identity theft.



SOURCE: Federal Trade Commission

edge) or e-mail scams that link to bogus Web sites, the account would be unavailable to an imposter.

Davis, like Scott of Wachovia, would not discuss how much SiteKey has cut into the bank's bottom line or how big a problem identity theft is for Bank of America.

Even with risks associated with spyware, consumers might do well to bank online, along with 44 percent of all Internet users and 25 percent of adults who now do so. "Because I'm logging onto my account daily or weekly, I would be the first to notice, 'Gee, I didn't write that check,'" says Celent's Moore.

Still, cyber crimes are increasing and that is expected to slow e-commerce growth rates by 1 percent to 3 percent, according to Avivah Litan of the information technology research firm Gartner Inc. Phishing attacks, for example, reached an estimated 73 million U.S. adults in the 12 months ending May 2005, a 28 percent increase over the previous 12-month period.

Social Insecurity

While data dissemination and malicious Web work has driven identity theft, most thieves still get their information the old-fashioned way. In cases where the method was known, the Javelin Survey reports 68 percent of information was gleaned offline compared to 11.6 online. The most common methods include lost or stolen wallets, misappropriation by family or friends, and mail theft. That's how Lisa Cook's imposter got her Social Security card — her wallet had been stolen.

It's no wonder that Social Security

Numbers as identifiers have come under increased scrutiny. "It's overwhelming when you look at the big picture of identity theft and the opportunity," notes Ariana-Michele Moore of Celent, referring to peoples' relationships to organizations. Between landlords, employers, background checks for even volunteer work, it's important for people to realize how available their personal information may be.

Social Security Numbers (SSNs), names, and birth dates, are the prized identifiers for identity thieves, according to the U.S. Government Accountability Office in reports in 2004 and 2005 that examine the exposure of SSNs. The numbers were first used in 1936 to track workers' earnings, but now SSNs are collected widely. The GAO reports the numbers are often available in public records, especially state and local government records. The GAO reported in 2004 that state agencies in 41 states and the District of Columbia displayed SSNs in public records. This was also true in 75 percent of U.S. counties. It has been used on drivers' licenses and insurance cards, including Medicare and government-issued insurance cards.

Data resellers, credit reporting agencies, and health care organizations use SSNs. Information resellers may obtain the numbers from records, including court records such as bankruptcies, real estate transactions, voter registrations, and professional licenses or from business clients. In 2003, the GAO investigated Internet-based information resellers to determine what information might be available.

The investigators paid fees and supplied several resellers with legitimate SSNs, and in return received information based on those numbers, such as a name, address, telephone number. During the investigation, none of the Internet-based resellers bothered to verify who they were or whether they were using the information for the purpose they'd indicated.

As Lisa Cook discovered, if a thief has your Social Security Number, he's got a good head start on fraud. Twenty-nine percent of identity theft victim complaints in 2004 came from people aged 18 to 29, according to the FTC. In the European Union, identity theft isn't as big a problem, and some experts have suggested it's because Social Security Numbers aren't universal identifiers. In Europe, residents have national identity cards and Social Security Numbers are used solely for retirement benefits. Privacy laws keep businesses from sharing and selling personal or private financial information. Of course, the price they pay is slower credit decisions.

But some "red flag rules" are coming, under the Fair and Accurate Credit Transactions Act, the law passed in 2003 that gives consumers one free annual credit report for the asking.

Lisa Cook is still asking herself how the thief got away with using his name with her number for so long. She'd built up a good report by paying her bills on time.

"I already had stuff on there [credit report], but it was all good, until he came along." **RF**

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The Sea Island Hurricane of 1893

BY BETTY JOYCE NASH

Before hurricanes carried names and price tags, like New Orleans' Katrina (estimates start at about \$100 billion) and Florida's Andrew (\$44 billion) and South Carolina's Hugo (\$12 billion), a nameless storm slammed the islands clustered off Georgia and South Carolina. These islands were home to descendants from Africa, former slaves who were of the Gullah language and culture. Beaufort County, S.C., which includes many sea islands, got the worst of it.

It would be tempting to compare the "big blow" with Katrina, as the nation watches money and effort being plowed into rebuilding New Orleans. But that would be facile and off the mark. Still, history is sobering, if not always perfectly instructive.

With little communication and no means of evacuation from the bridgeless islands, upward of 2,000 people (only two of them white) died in the 1893 storm. But starvation following the hurricane was an equal opportunity problem, with blacks and whites alike on survival rations, and only Clara Barton's American National Red Cross to help feed and clothe them.

The storm of 1893 was one of three big hurricanes to hit coastal South Carolina in one decade, but it was the 1893 big blow that sank Beaufort County into an economic slumber and great migration, from which it didn't begin to awake until the government invested in the Marine Corps base on Parris Island in the run-up to World War II, according to Lawrence Rowland. He is professor emeritus of history at the University of South Carolina at Beaufort, and has written a history of the county.

Today, Beaufort County is prospering, with the highest per-capita

income in the state. Although there's little industry to speak of, three military installations account for about a third of the economy. Tourism and real estate are the other two legs.

Where starving black people 112 years ago dug ditches to reclaim flooded fields, half-million dollar homes and golf courses edge coastal marshes and rivers on dozens of islands strung out along the coast. Descendants of barefoot farmers who scratched out a living 112 years ago cross the bridge to resort town Hilton Head, Rowland says. There, they work in service industries created by retirement and tourism, or perhaps they work for the government at wages 40 percent higher than everyone else in the county.

Before the Storm

Phosphate mining was the biggest industry in Beaufort County when the storm crashed the coast on Aug. 27, 1893, with its 15-foot seas.

Phosphate, used in fertilizer, was discovered in rivers in and around Beaufort County around 1867, according to Rowland. From about 1870 until 1893, 60 percent of the phosphate produced in the United States came from South Carolina, and half of that was mined in Beaufort County. People could earn something like \$2 to \$5 a day, a decent wage at the time. "The vast majority who worked there were freedmen, black Sea Islanders," Rowland says.

Most of Beaufort County was black, according to the 1890 Census, about 31,400 people. There were about 2,700 white people living in the county at the time.

"Absolutely the history of Beaufort County would have been different if the hurricane hadn't wiped out the phosphate industry," he says. "How remarkably prosperous

The storm killed more than 2,000 people and plunged Beaufort County, S.C., into an economic decline

Clara Barton (forefront, third from right) and her American National Red Cross distribute food on Lady's Island, one of the Sea Islands.



it was before 1893 and then drifted into abject poverty over the next 30 years.”

Most Sea Islanders, freed from slavery when the Union captured Beaufort County in 1861, kept plots of sweet potatoes and vegetables to feed their families, and one of cotton, used to obtain cash. There were some black merchants and professionals, mostly in the town of Beaufort. White people farmed, owned businesses, worked as doctors and lawyers as well as in the maritime trade or on the railroads as machinists, Rowland says. Most whites lived inland. The black people who lived on the islands typically lived in frame homes, with shutters against the wind. The swampy, mosquito-ridden islands were magnets for disease.

“Roofs were made of rough-hewn native wood shingles, chimneys of worn bricks,” write Fran and Bill Marscher in *The Great Sea Island Storm of 1893*. Bill Marscher’s grandparents lived through the storm, and the newspaper stories he found as a child inspired and informed the book. “On the islands’ sandy two-rutted roads, the people traveled by foot, by horse, or by two-wheel ox cart.” It took a boat to leave the islands.

The phosphate industry was on the wane even before the hurricane hit, as huge and efficient deposits had been discovered in Florida in 1888, Rowland notes. But the hurricane nailed the industry for good in Beaufort by destroying the barges and boats and other infrastructure.

The cotton industry, too, had declined under competition from Egypt and India. The long fibers of Sea Island cotton, almost like silk, had brought premium prices until growing international supply drove prices down. However, most of the Sea Island farmers grew a bale a year just to bring in a little cash. The storm did away with that too.

Rowland believes the hurricane accelerated migration from the county. “You can see it happening [in census data] and I believe the principal

reason was the hurricane in 1893. It was not the only hurricane. There were five hurricanes in 10 years in the Sea Islands.”

Another pre-storm investment was the U.S. Naval Station at Port Royal, tucked on the Beaufort River off the Port Royal Sound. By 1901, the naval jobs were gone. “What happened, in essence, was that after the hurricane the Navy wasn’t sure they wanted Port Royal Sound anymore,” Rowland says, adding that politics also played a role in that decision.

“Here were all these jobs, the naval shipyard, and phosphate; by 1901 they were all gone,” he said. That threw the county into a depression from which it didn’t recover until after World War II.

The Human Suffering

The winds of August 27, 1893, exceeded 115 miles per hour and brought in a high tide of perhaps 15 to 20 feet or more in places. The storm killed more than 2,000 of some 31,400 black people in Beaufort County.

No federal or state money flowed. South Carolina’s Gov. “Pitchfork” Ben Tillman first advised people to plant turnips. The work of relief was left to the fledgling American National Red Cross and its president, Clara Barton. The storm destroyed people, homes, and land. And it did away with the remnants of South Carolina’s rice plantations.

“The killer hurricane, another ‘strong force,’ hit the state’s coast in the worst possible place — the flat, remote Sea Islands,” according to the Marschers’ book. “It hit at the worst possible time — near the end of harvest season, on high tide. Its violence was most ruthless against the nation’s most vulnerable citizens — former slaves and their offspring, the Gullahs.”

There was no way to get word to people living on the islands off South Carolina and Georgia, even though ships’ reports telegraphed from Washington sent storm banners flying in Charleston, Savannah, Ga., and Wilmington, N.C.

Here is a firsthand account from the diary of Margaret Weary, of the Beaufort Industrial School for Girls:

I was so busy that evening cooking supper I never minded the wind and rain, nor the great roaring of the waves, till I looked out through the shutter and saw the sea all around the house. Then we were all frightened, as we saw the waves rushing up to the door. Ma seized my little sister, Grace, wrapped her in a blanket and ran to a neighbor’s house on the hill. Brother and I jumped out into the water and ran as fast as we could, but I fell down into the water, my brother picked me up, and we pressed on through the waves till we reached the house where Ma was. The water had come up all around that house, too, and so we had to run to another, up on higher land, and there stayed all night.

Next morning we went home, but there was no house there, nor anything left. All had been washed away into the marsh, and the sedge and sea weed were piled up all around higher than my head. We saw dead cats and dogs, dead horses and hogs all along the shore, and some dead men and women and children. We saw one dead woman holding on to a timber of her house by her teeth.

Many of the Gullah believed in spirits, and if someone drowned, his soul was in limbo. And there were many, many in limbo.

Survivors were in a limbo of their own, with no food, water, clothing, dwellings, nor even soil in which to plant crops.

Clara Barton Returns

It was four days before even Gov. Tillman found out about the extent of the island damage from a telegraph pleading for relief. The governor responded by asking for donations. Local relief committees formed, and railway cars of food arrived in Beaufort, with 2,500 loaves of bread, 25 pounds of corned beef, 100 boxes of soda crackers, 50 barrels of grits, and five barrels of molasses.

“Although the governor expressed compassion and pleaded for donations from the public, he grossly underestimated what it would



The chief field agent for the American Red Cross, Dr. Hubbell, looks over ditches dug by hurricane survivors. The flooded lands needed to be drained so crops would grow.

take to relieve the suffering . . .,” the Marschers write. The governor suggested that the islanders could eat fish. But, of course, they had no boats.

Finally, the governor, with overwhelming evidence of the calamity, called on the American National Red Cross three weeks after the storm. Clara Barton, founder and president, took charge.

Barton had spent nine months during the Civil War on Hilton Head, then occupied by Union forces. She arrived in mid-September to sick, sleep-deprived, hungry, naked people who had only water from brackish wells to drink, no food, and no shelter.

Barton had to feed 30,000 people with a mere \$30,000 in donated funds, until spring crops could be harvested. Her appeals to the state Legislature and U.S. Congress were denied.

Barton, who was 72 at the time, set up warehouses in Beaufort, her desk a dry goods box with a homemade drawer. Each family of seven was given a peck (eight quarts) of hominy grits and one pound of pork weekly.

People who worked digging ditches and building homes or otherwise helping out could earn double rations. Donations of seeds, food, money, and clothing poured in from the North. She established sewing circles.

Still, starvation hung over the county like a black cloud, even into June 1894 — 10 months after the hurricane. Racial tensions broke out when whites in Bluffton claimed they weren’t getting food because they were white, not black.

Eventually, the residents made headway. They constructed homes, dug ditches to drain the land, and planted spring crops. Barton folded her relief operation in May of 1894:

“If it is desirable to understand when to commence a work of relief . . . it is no less desirable and indispensable that one knows when to end such relief, in order to avoid, first, the weakening of effort and powers for self-sustenance; second, the encouragement of a tendency to beggary and pauperism, by dependence upon others which should be assumed by persons themselves.”

A Throwback: St. Helena Island

St. Helena Island today is one of the few without the golf resorts, the big homes, and immaculate landscaping of the retirement villages that have sprung up on the coast in the last 40

years. Driving along, you might see a couple of small shops or an art gallery by the side of the road or pass a truck loaded with watermelons headed for market.

St. Helena, for one thing, is largely still black-owned. It’s the home of Penn Center, a former school for black children dating from the Civil War era, which now serves as a repository for research and gatherings about the Gullah culture. The land has been hard for outsiders to develop because it’s chock-full of tiny plots, with unclear title to ownership. After the Civil War, Rowland explains, many freed slaves bought land there in federal government sales.

“St. Helena may have been the largest concentration of independent black landholders in the state,” he notes. “It’s created an awful lot of ‘heirs’ land’ where there are so many heirs, one can’t determine the owner, and that’s retarded real estate.”

And so without the strip malls and lush subdivisions, the traffic roads are calm, even on a brilliant October day when marsh grasses glow in the distance.

With another “big blow” . . . well, the story would be different today. While early warning systems could help mitigate the cruel loss of life of 1893, the economic price tag would be calamitous, given the population and escalating development. Were the storm of 1893 to hit today, the damage is forecast at \$50 billion, given current population and buildings.

Rowland, a Beaufort native, has moved to higher ground on Dataw Island, 25 feet above sea level. Just in case. **RF**

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Tyler Cowen

People generally agree that markets are the most efficient way to allocate resources. In short, they deliver the goods. One exception, some critics say, is culture. Markets respond to mass demand and, as a result, produce inferior, homogenized art. Consider movies. Hollywood makes plenty of special effects laden blockbusters but neglects thoughtful dramas and documentaries.

You might be tempted to dismiss such arguments as mere snobbery. After all, a lot of this criticism boils down to one person wishing to substitute his own (supposedly refined) preferences for another's (supposedly gauche) tastes. But there is a larger point to be made, says Tyler Cowen, an economist at George Mason University. We don't live in an either-or world. Many different types and forms of art can — and, in fact, do — peacefully coexist. Markets cater to a multiplicity of wants, and nowhere is this more apparent than in the United States. To borrow from the title of his forthcoming book, we live in a world of both good and plenty.

Cowen started his academic career largely pursuing topics in monetary economics. But his interests have always been eclectic, and in the early 1990s, he began to shift his attention toward the economics of culture. The result has been a string of books and papers that examine the current state of the arts and the conditions under which they flourish. In addition, since 2003, he and his colleague Alexander Tabarrok have maintained one of the most popular economics blogs, marginalrevolution.com.

Aaron Steelman interviewed Cowen on the George Mason campus in Fairfax, Va., on November 21, 2005.



RF: How did you become interested in looking at the arts from an economic perspective?

Cowen: When I first started learning about economics in the 1970s, economic conditions were very bad. We had sluggish growth and high inflation. My early work tended to focus on macroeconomic and monetary questions because they seemed very pressing and important. But for the past 20 years, macroeconomic conditions generally have been good, and the policies pursued by the country's central bankers have improved a great deal. This, obviously, is wonderful. But, in a sense, it has made those fields much duller. Don't get me wrong: I don't think all the key problems and questions have been solved, but their policy relevance has become less pressing.

My professional interest in the arts began to emerge about 15 years ago when I spent some time in New Zealand. Their central bank had one of the first versions of inflation targeting, and I was hired as a consultant to come in and look at that. While I was there, I realized that I didn't want to do just money and macro. So I started thinking about some of the niche areas in microeconomics. One of these was the arts. I thought that this was an area that had been underexplored and

where I had some original things to say. I started my work on the topic around 1990. The output came quite a bit later because there was a lot of work involved, more than just doing conventional economics. I spent five or six years writing my first book in the area, *In Praise of Commercial Culture*, and from there my next few book projects became pretty clear. They were just extensions of that first book. In fact, much of their content came from chapters that had been cut from the original manuscript of the first book.

RF: What are your thoughts on the “cost disease” as it relates to the arts?

Cowen: In the mid-1960s, William Baumol and William Bowen advanced the hypothesis that the arts would experience lower productivity gains than other sectors of the economy, and therefore would suffer from the “cost disease.” The analysis gets a little complicated, but one thing I have tried to argue is that the initial assumption that productivity gains would be low simply isn’t true. If you look at music, in the last century we have seen the introduction of radio, compact discs, and now MP3 files. In addition, it’s easier than ever to order music through places like Amazon, and it’s cheaper to sample many different types of music. Also, the reduced cost of travel has made it more affordable to go to concerts and experience live music. So I think the cost of consuming music has fallen dramatically, and people enjoy much more music in a much more comfortable way than they did in the past.

Consider how people consumed music throughout most of the 19th century. There were no recordings until the latter part of the century — and the recordings that were available were much more expensive than they are today. Instead, people had to travel by wagon, often for many hours, to see a live performance. And when they got there, the acoustics often weren’t very good. It was simply very difficult to listen to music. So I think that the premise of the argument made by Baumol and Bowen has been overstated. Some subsectors will experience a lower than average rate of productivity growth. But, on balance, there is plenty of room for the arts to reap productivity gains, and we have seen it time and again.

RF: Looking at the music industry today, we see that while the cost of traveling to concerts has been going down over time, the cost of concert tickets has been going up. Are artists trying to make up some of the revenue they are losing through illegal downloading of their studio albums by raising the price of attending a live show?

Cowen: Yes, I think so. The people who download illegally tend to be younger listeners. That means you are left with a market of older listeners, richer listeners, and less price-elastic listeners. So for concerts and some CDs, the cost will go up.

I think we have moved from a regime where de facto copyright enforcement was too strict to one where it is too relaxed. Illegal downloading, in one form or another, will continue. Lawsuits will put a dent in it, but it won’t fundamentally stop it.

As a result, commercial music won’t dry up, but some margins will get squeezed. World music will do just fine. Jazz will do just fine. And classical will do just fine. The average listener of those types of music is going to purchase it, not download it illegally.

But if you think about popular music, there is one segment that I think will be hurt: musicians with moderate-size fan bases whose work requires a lot of studio time. It will be very hard for them to recoup their production costs. Popular groups that don’t spend much time in the studio will do fine. They don’t require a lot of capital, and they earn a lot of their money from touring anyway. And the huge superstars, like Madonna or Eminem, will be fine also. Their CDs will sell because there’s a fraction of the population that will always want to be part of the club, so to speak. So, as I said, I don’t think illegal downloading will mean the end of commercial music. But some segments of the market will be hurt quite badly.

RF: People who support the National Endowment for the Arts (NEA) and the National Endowment for the Humanities (NEH) claim these agencies are necessary to remedy market failures that are present in the arts. What do you think of that argument?

Cowen: I think that the American way of subsidizing the arts has mostly been indirect, through the tax treatment of nonprofit organizations, through the public funding of universities, through copyright laws. Those policies have done quite a bit to remedy the market failure problems that do, in fact, exist in the arts. But direct subsidies have not been at the forefront of the approach. And those direct subsidies, in purely quantitative terms, are very small.

I think the more important issue is how tax reform would affect nonprofits and the arts. To me, that’s a more fruitful debate than how the NEA should spend its money. For instance, the President’s tax commission came up with a proposal to reduce tax deductions for some kinds of nonprofit organizations. In my view, that would be a mistake. I have a Tocquevillean sympathy for the proliferation of intermediate institutions which we call American civil society. I think the strength of those institutions enables us to get by with less government intervention than many other developed nations. So in the long run, if we moved to a truly flat tax system that removed the favorable tax treatment for nonprofits, I think we would harm the decentralized production of ideas and art.

RF: I would like to consider the issue of market failure more broadly. How widespread, in your view, are examples of market failure? And have economists who generally favor a hands-off approach to public policy not adequately addressed those cases where market failure arguments are plausible?

Cowen: I believe market failures are virtually everywhere. The key question is comparative: Where will government do better? I think of myself as a libertarian, and compared to public opinion as a whole, my views certainly are libertarian. But the case

for the market is empirical, and I think that there are plenty of cases where it is desirable for the government to do something. One example is the avian flu, which I hope we will get to later. I also think, though, that there are many cases of market failure where the government shouldn't do anything. In principle, we could come up with programs that would improve social welfare, but in practice those programs would be difficult to implement effectively. Also, I think there is a good argument for the notion that a government can do only a limited number of things well. In the big picture, you have to choose priorities, and that means you have to let some share of market failures slide.

RF: Please tell us about your next book, *Good and Plenty*.

Cowen: The book is coming out in the spring from Princeton. In it I attempt to unify the economic perspectives on the issue of art with the aesthetic perspectives, and to ask what are the types of policies that would produce a system of artistic production that is both efficient and aesthetically pleasing. I argue that the American system, to a considerable degree, does that. It is not perfect on either dimension. But on the two taken together, I think it does better than any other. In one sense, then, the book is a defense of and apology for the American system. And in another sense, it's a return to the classic social science question of how America and Europe relate to each other, and what are their relative virtues and drawbacks.

RF: Is there a real danger that globalization will lead to the effective loss of some cultures' most important and distinguishing characteristics? And if so, is this something that we should worry about?

Cowen: There are plenty of cases of small, indigenous cultures using the market to make a living without people having to migrate to big cities. That being said, I think it's true that some very small cultures — their language is spoken by 50,000 people or fewer, they have their own tribal rituals, etc. — are, in fact, disappearing. But I think they are disappearing largely for good reasons. People want jobs, access to antibiotics, and better schools for their children, so they move to urban areas. However, those people are not completely abandoning their identities or ceasing to be creative. They are blending with their new cultures, rather than being overtaken by them. We see this in places like Mexico, Brazil, and Nigeria, where people are moving from rural to urban areas. This process, by itself, doesn't bother me, as long as it is being driven by economic growth. I think it's hard to dismiss people's desires to improve their own lives and the lives of their children, and for many, this is what moving to cities means.

RF: Your last answer suggests that it is sometimes difficult to divorce normative concerns from positive economic analysis. What do you think is the proper role for normative evaluations in economics?

Cowen: I don't think we have ever had a good welfare economics.

When you think of Paretian theory, it's very useful, but we never have been able to explain to the common man or to philosophers why efficiency should be the only relevant value. As economists, we have taken a real beating on this, time and again, and we have lost those debates. For example, when Richard Posner debated wealth maximization with Ronald Dworkin in the early 1980s, I think it's pretty clear that Dworkin got the better of that exchange, yet economists are still looking at wealth maximization.



So I think there are a lot of interesting normative issues in economics. I'm not sure we will ever have definitive answers, but I think we should be willing to entertain more values than what is possible by doing simple Paretian analysis. This is important for its own sake, but I think it would also help us understand why economic recommendations are often found to be unpersuasive. In my work on the economics of the arts, I have come across this all the time. Most people don't accept the efficiency argument at all. They want art for art's sake. I would like to think that we have some way of speaking to people like that and developing a common language. And I think that a good system for the arts would do well on both economic criteria and aesthetic criteria.

RF: Why do you think so many people object to the way economists think about rationality?

Cowen: Well, I think there is some blame on both sides here. Economic models of rationality are centered around self-interest. It's true that you can factor in altruism in these models to some extent, but the self-interest idea remains paramount. And that may not be entirely realistic. But I also think that many people don't like these models because they strip away a veneer of self-deception. You often hear the claim that various social phenomena are so complex that they can't be explained by mere self-interest. Perhaps, but I think that is a way of whitewashing some very unpleasant things that go on in society.

RF: You clearly have a significant interest in cuisine. And many people clearly value your opinions on the topic — your "Ethnic Dining Guide to the Washington, D.C. Area" is now in its 19th edition. How can economics help us understand food and the way people eat?

Cowen: This relates to my work on globalization and culture more generally, which asks the question: Does greater trade,

investment, and migration across borders give us more or less diversity? And a great deal of those debates are about food. For instance, you see a great many people who are upset about McDonald's and Pizza Hut establishing restaurants around the world. So my attention was drawn to the food area, and I think from an economic standpoint, it offers a case study of the diffusion of innovation.

Why is barbecue in Lockhart, Texas, so much better than barbecue in Fairfax, Virginia? The answer is not immediately obvious. One would think that there is considerable demand in both areas, yet the markets are very different. In part, I think it has to do with the spread of social customs and regional identity. And, in part, I think it has to do with differing legal and regulatory structures; for instance, Lockhart's barbecue establishments would not meet the fire, health, and safety codes that exist in many areas, including Fairfax. Also, why do some types of food lend themselves to chain establishments while others do not? For example, most doughnut shops now are part of chains, but barbecue chains generally haven't done very well. To understand that question, you need a fair amount of economics. So what I hope to do with my work in this area is to use food as a vehicle for discussing larger economic truths, and to reach an audience of people who might read books about food, but not necessarily books about economics.

RF: Some people have argued that globalization will induce more countries to adopt the type of "neoliberal" policies that characterize the United States, and abandon a more interventionist approach. How has your work on globalization led you to think about that issue?

Cowen: I don't necessarily agree. My prediction is that, in general, welfare states will increase in size in most places around the world. We can expect most areas of the world to become wealthier because of globalization as well as other reasons. And if you look at countries that are wealthy, they tend to have very generous welfare states. Also, I believe that the human desire for security is extremely strong, even when it is not efficient or rational. So as long as we experience economic growth, I think we can expect welfare states to grow.

RF: If the process you described in your previous answer is correct, what does that mean for economists who favor a

Tyler Cowen

➤ Present Position

Holbert C. Harris Professor of Economics, George Mason University

➤ Previous Faculty Appointments

University of California, Irvine (1987-1989)

➤ Education

B.S., George Mason University (1983); Ph.D., Harvard University (1987)

➤ Selected Publications

Author or co-author of several books, including *Explorations in the New Monetary Economics* (1994), *In Praise of Commercial Culture* (1998), *Creative Destruction: How Globalization Is Changing the World's Cultures* (2002), and *Good and Plenty: The Creative Successes of American Arts Funding* (forthcoming), and papers in such journals as the *American Economic Review*, *Journal of Political Economy*, *Public Choice*, and *Ethics*

➤ Other Activities

Serves as General Director of the James M. Buchanan Center for Political Economy and the Mercatus Center, both at George Mason University. Maintains the economics blog, marginalrevolution.com, with his colleague Alexander Tabarrok.

less interventionist, more market-oriented approach to social policy? Do their arguments become futile?

Cowen: I don't think so. Free-market economists are unlikely to see their most preferred policies enacted. But their work can help slow down or even stop very bad ideas from becoming policy. So their arguments do matter. That's important. Still, there is a broader issue here. As social scientists, our foremost concern should be trying to understand the world. That means asking and perhaps answering very hard questions. Trying to convince the public — and especially trying to get people to march in lock step — should be a secondary concern.

Having said that, I don't want to give the impression that academics should look only to the frontiers of their disciplines. For instance, the work being done in economics now is very rigorous and very good. But if I have one criticism of the profession, it's that there is too much emphasis on doing highly specialized research and not enough emphasis on consuming what is already out there. Most of us could benefit a great deal from a better understanding of work that has already been done.

RF: You wrote a paper called "Why Only Nixon Can Go to China" that was published in *Public Choice*. Can you talk about that paper and some more recent applications where the argument is relevant?

Cowen: The basic premise of that paper is that it often requires a politician who is believed by the public to be tough on a particular policy to make a significant change in that policy. In short, Nixon was able to open diplomatic relations with China because he was seen as such a staunch anticommunist. But George McGovern would have had a hard time doing the same thing because his anticommunist credentials were not as strong.

We see a similar thing happening now with fiscal policy. The Republicans campaigned on a platform of fiscal austerity. But even on domestic discretionary items, they have been spending through the roof. There are two possible mechanisms by which this can happen. One is a signaling argument. If the party that you think ought to naturally oppose a policy instead supports it, some people will think that it must be really important and that we must really need it.

The second is an interest-group argument. If you think of parties on each side of the spectrum as having natural interest

groups — Democrats have unions, Republicans have Wall Street — then the party and the interest group have a long, ongoing relationship, and the interest group is going to be reluctant to break it. So even though the Republicans' interest groups might oppose increased federal spending, they are going to tend to stay quiet, but if Democrats were in power, they would scream bloody murder. The same thing is true on the Democratic side. Clinton was basically for free trade and fiscal restraint, and he was fairly moderate on regulation. Many Democratic interest groups didn't like those policies, but they weren't particularly vocal in opposition because they felt they had no place else to go.

RF: Please tell us about your debate with David Friedman over the economics of a stateless society.

Cowen: David Friedman wrote a book called *The Machinery of Freedom: Guide to a Radical Capitalism*, which is very stimulating. He makes the claim that all services — including police, courts, and final adjudication — could be privatized. I'm skeptical that this would work. I'm willing, for the purposes of argument, to accept Friedman's claim that it would have a certain stability. But I think that the final level of adjudication is a type of natural monopoly. Once you imagine these private insurance and protection companies collectively making deals, it's a short step from that to widespread collusion, and you would be back to government. So what I tried to do was to give the anarcho-capitalist argument its fairest hearing, but even then I don't think it would work. I believe you would quickly wind up with government again, so I think of government as a constraint, not a choice.

Also, when you look at places without government, they tend to have many undesirable characteristics. Think of Somalia. Friedman, of course, would point to other examples, like medieval Iceland. But those examples don't show what he believes they show. There is a critical watershed in the developed world in the late 19th century. For the first time you get large institutional structures — in particular, big business and big government. Medieval Iceland did work fairly well, but it didn't have large-scale structures. So to say that it didn't have government I view as correlate with the fact that it didn't have a lot of other things either. To think that system would work in the post-1870 world, I believe, is just not true. You might begin in a world without government, but things would quickly evolve so that government would be present.

RF: Why did you and Alex Tabarrok decide to launch marginalrevolution.com? What have been some of the principal benefits of maintaining the blog? And what, if any, have been the downsides?

Cowen: It has been about two years and three months since Alex and I launched marginalrevolution. At the time it seemed

clear to us that blogging would become important, but there was very little in the way of economic blogging. Even now, there are relatively few economic blogs compared to many other areas. We thought this would be an opportunity for us to jump in and help define what economic blogging would be. It would be educational, but it also would be fun. And unlike a lot of blogging, it wouldn't consist of personal attacks or partisan politics. Instead, we would try to push the frontiers of how we think about economic issues and see how well that could be communicated in this new medium.

It's gone very well for us. We have found an audience, and judging by the comments we receive, a well-informed, thoughtful audience. It's given us a way of

communicating to people who we couldn't have reached any other way. And I think I have learned more working on the blog than I would have with any other use of the time. The success of the blog actually makes me nervous. I get up every morning and wonder who is going to read us. In a way, that has a disciplining effect — it makes you think hard about an issue before writing about it, rather than just throwing down your first thoughts on a topic.

RF: As a senior faculty member, how would you advise a more junior colleague who is considering starting a blog?

Cowen: I wouldn't necessarily discourage blogging. My guess is that junior faculty who end up blogging get more research done than those who don't. But that's not because of the blog per se. Rather, it's because those people are probably more ambitious and have more fertile ideas than the typical junior faculty member. So, on average, they would have been high producers anyway, and the blog simply complements their scientific work.

That said, I think that academics who blog have more of a generalist approach to their work than those who don't. Their professional interests usually are not in highly arcane, technical areas, but in fields with more general applicability. And insofar as there is an antigeneralist bias in the modern academic world — and I think there is — bloggers tend to suffer. There is a recent high-profile case of a blogger who was denied tenure that I think is consistent with this argument. His professional work was, by most accounts, very good and the volume was certainly large, but he didn't mine a narrow field over and over again. That was probably a more important factor than the blog in his tenure decision.

RF: You have written quite a bit about the avian flu. What is the potential magnitude of that problem? And what, in your opinion, should policymakers do — and not do — in response?

Cowen: Right now, there is more H5N1, a particularly dangerous strain of avian flu, in more birds in more parts of the

What policies would yield a system of artistic production that is both efficient and aesthetically pleasing?

world than ever before. It's also the case that many humans are catching H5N1 from birds, especially in southeast Asia. So it's already a serious problem. In the countries where the disease is most widespread, the poultry industry is very important, and most people are exposed to birds regularly. It's a major health issue. But the even bigger danger is that the virus mutates so that it's transmitted from one human being to another. We're not sure what kind of mutation would be required for human-to-human transmission, or how likely that is, so we don't know the probability of there being a pandemic.

It's believed that the 1918 flu virus — which was a form of avian flu — killed 50 to 100 million people worldwide. Transportation is much better now and people move around the world with much more ease, so it's possible that the virus could spread more quickly. And even though the world has much better health care, if there was a surge of demand for services, most people would not be helped, especially in relatively poor countries with large populations, such as China and India. So there's potential for catastrophe.

The question of what we should do is difficult. We don't have many good remedies at our disposal in the short run. Most of our vaccines now come from abroad, but in a pandemic they wouldn't be exported. So we would be at loose ends. In the long run, we should do more to help the vaccine industry. When it comes to antiviral drugs and vaccines I would argue that we should protect rather than confiscate intellectual property. I would buy the vaccines using government money at a favorable price, because if the government just seized them, companies would have little reason to produce them the next time around.

In the short run, the best we can do is to have well-functioning local health care institutions, especially emergency rooms with good backup plans. Let's say your emergency room is booked up with people who have already contracted the flu. How do you deal with everyone else? Should they stay at home? Do they get sent to another part of the hospital? We are starting to do planning, but we are very much behind.

There are many proposals that put a lot of faith in building up a stockpile of the vaccine. I'm not saying we shouldn't do that, but I think it's probably overrated. If a pandemic came, the chance that the stockpile would be allocated efficiently and in time is small. Also, some people have called for quarantines, but that wouldn't work in a country like the United States. When discussing this, I think it's important to distinguish between "isolating" and "quarantining" people. Isolation would mean keeping an infected person in a different wing of the hospital. I think that makes sense. Quarantine is when you try to close off a particular area — all traffic, commerce, movement — usually through the use of the military. But if a pandemic came, it would hit virtually every major city in the country at the same time. It would be so geographically dispersed that quarantines would be futile. Also, there's the simple question of where you draw the line. Consider Fairfax. Is it Route 236? Is it I-95? Is it the Beltway? You don't know how far it has spread, so the line is arbitrary.

So the bottom line, I think, is that we need to have some humility. If a pandemic occurred soon — and, as I said, no one knows the probability of this occurring — we would be in real

trouble. There is no magic bullet. But we can use economics to help us prepare for the long run, so that in, say, 10 years, we would be in a better position to deal with this problem. Also, some of the things that I mentioned we could do in the short run — such as improve our local health care institutions — would help us deal with any catastrophe, including another terrorist attack. So that would pay off whether or not there is an avian flu pandemic.

RF: George Mason has a reputation of being perhaps the most market-oriented Ph.D. granting department in the country. Please tell us a little bit about the series of events that led to the department's current complexion.

Cowen: Jim Buchanan, Gordon Tullock, and the Center for the Study of Public Choice came here in 1983. That was a big group all at once. And obviously the people who recruited them — which included some economists who were sympathetic to the Austrian School — liked the work they were doing. Then a few years ago, Vernon Smith and his colleagues doing research in experimental economics arrived. So you had three groups of economists — the Public Choicers, the Austrians, and the experimentalists — who were all pretty friendly to a market-oriented approach to economics. In the meantime, both our department and the law school began to attract a number of people who were interested in doing law-and-economics work. So there were some cluster effects, I think. Academics benefit from being around people who share similar research programs, and we have seen that happen at George Mason.

RF: Early in your career, you tended to publish mostly in journals, many of them quite prestigious, but most of your work recently has appeared in book form. Has this been a deliberate choice?

Cowen: Yes. I think journals have become less receptive to "big idea" papers that can spark a serious debate and literature, and more inclined to publish papers that make incremental contributions to an existing literature. There is certainly value in the latter type of work, but it interests me less now.

There is also something about writing a book, where you live with a topic for several years, that I find personally attractive and exciting. If there is something that I am really interested in, I don't want to let go of it until I have been able to say what I want about it. With papers, you can do follow-ups, but they just are gone too quickly for my satisfaction.

RF: Which economists have influenced you the most?

Cowen: Hayek influenced me from a very early age. Thomas Schelling was a mentor of mine in graduate school. And my colleagues have been extremely influential. We have very stimulating conversations every day. Also, I would say that reading broadly in philosophy, fiction, and other areas outside of economics has influenced my thinking and my work. **RF**

Not by Bullets Alone

DEALING WITH TERRORISM — STICK OR CARROT?

BY BRUNO S. FREY

NORTHAMPTON, MASS.: EDWARD ELGAR PUBLISHING, 2005, 182 PAGES

REVIEWED BY AARON STEELMAN

A man straps a bomb to his body, walks into a crowded market, and detonates it, killing himself and dozens of others. Is he rational? If you're like most people, you probably doubt it. But consider: The terrorist has goals and acts systematically to attain them. Bruno Frey, an economist at the University of Zurich, says this makes him rational — and, as a result, subject to economic analysis.

In his book, *Dealing with Terrorism — Stick or Carrot?* Frey argues that conventional approaches to dealing with terrorism are flawed. Relying on coercion — especially the use of force against terrorists and countries that harbor them — can be counterproductive. Instead, he would like to see incentives used to induce terrorists to refrain from violence and to prevent potential terrorists from joining organizations like Al Qaeda.

Such a reorientation of policy would turn “the whole interaction between terrorists and the government” into a positive sum game, in which both sides benefit. The government would expend fewer resources on costly military interventions. And the terrorists would be given an opportunity to alter their current circumstances, which otherwise could lead to eventual incarceration or death.

Frey calls this the “economic approach” to analyzing terrorism. Its guiding principle is that terrorists “compare the costs and benefits of alternative actions.” When the benefits of engaging in terrorism rise, they engage in more of it. And when the costs rise, they engage in less of it. The key is to reduce the benefits that terrorists receive from engaging in violence — and, in the process, increase the opportunity costs of those actions.

The Proposals

Frey has three general proposals to either reduce the frequency or effectiveness of terrorism. First, to encourage decentralization — in the economy, government, and society generally. A country with multiple power centers makes a terrorist attack less devastating. On Sept. 11, 2001,

terrorists were able to bring down the World Trade Center buildings, structures that were strongly associated with Western market capitalism. In that way, it was a significant symbolic blow. But it did not fundamentally cripple the American economy, which is quite decentralized, with production and decisionmaking taking place all over the country. Countries with more centralized economies — especially those in which government plays a strong role and economic activity is isolated to a few geographic areas — would probably face greater turmoil following a terrorist attack.

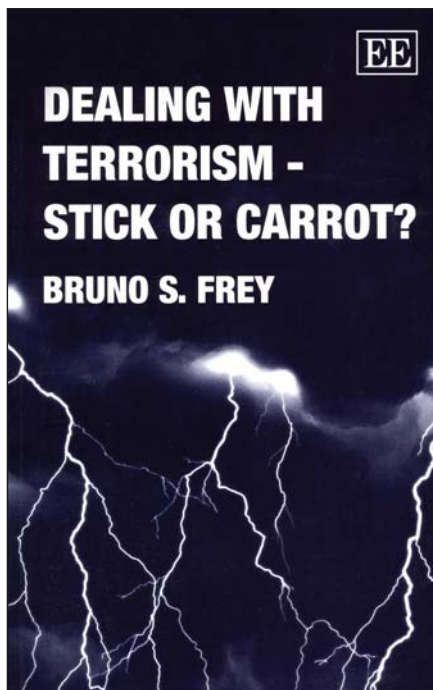
Second, to divert attention from terrorist groups. Consider the Palestinian Islamic Jihad (PIJ). It would like to see the destruction of the state of Israel and the establishment of a Palestinian state in its place. Members of the PIJ engage in suicide bombings and other terrorist attacks to further those goals. By taking such extreme action and having it broadcast around the world, these terrorists believe they can sway others who believe in their cause to support them and/or to scare those who oppose them to seek a compromise.

Frey suggests that when such an attack occurs, the government should simply decline to state which particular organization is responsible. This, he believes, would reduce the benefits that the PIJ would reap from such an act, because multiple groups with multiple goals, some of which are not necessarily consistent with the PIJ's, could plausibly claim credit for the attack. The act itself will have

been successful, but it will have done less to further the larger goal.

In addition, terrorist groups are often in intense competition with each other, even when they have similar beliefs. For instance, they may compete for the same group of possible new recruits. If one organization believes that another can “free ride” on a terrorist attack the first group commits, it's less likely to commit such an attack. By denying an organization credit for a terrorist act, you can deny it some of the attention and prestige it desires.

Third, to provide positive incentives for actual and potential terrorists to not engage in violent acts. By expanding the horizons of a potential terrorist, you can decrease the benefits and/or increase the costs of engaging in terrorism. If you are a



potential member of, say, Al Qaeda but get to know Westerners and understand their cultures and systems of government, you may become less likely to become a terrorist — for at least two reasons. First, you might sympathize less with Al Qaeda's goals. This reduces the psychic benefits you receive from joining a terrorist group. Second, you might come to believe that it is possible to improve economic conditions for you and your family. This increases the perceived opportunity cost of engaging in terrorism.

But how can potential terrorists actually gain such exposure to new cultures? On a micro level, Frey argues for a vigorous student exchange program. On a more macro level, he argues for reducing or eliminating sanctions against "rogue" states in an effort to bring them back into the international community. In addition, he argues that repentants should be welcomed. Terrorists who are serious about renouncing their actions and willing to provide information about their former associates should be given reduced punishments and guaranteed secure futures.

But Will They Work?

Frey's framework of analysis is persuasive. But some will remain skeptical, and argue that terrorists just can't be reasoned with in the way that Frey argues. Instead, the only thing they understand is violence — and we must adopt policies that recognize this ugly fact.

Is that necessarily inconsistent with an "economic approach" to dealing with terrorism? Arguably not. By using force or the threat of it, governments are raising the costs of engaging in terrorist activity — do so and you face the possibility of being killed or sent to prison. This clearly affects the decisionmaking process for terrorists. It's similar to taxing other activities deemed undesirable, such as smoking, only the consequences are much greater.

Military intervention, then, can be seen as broadly consistent with Frey's overall strategy of relying on incentives to alter behavior — although it does conflict with his more specific proposals. It's difficult to engage in military action without singling out a specific organization as responsible for terrorist activity. In addition, it's inconsistent with offering terrorists incentives to resist from further attacks and to reintegrate them back into peaceful society. In short, "deterrence policy is difficult to combine with the positive approaches," Frey offers.

Moreover, war is expensive — in terms of both blood and treasure. Just as important, it may exacerbate the problem. By invading and then occupying foreign countries, you can create great anger throughout a region — and, hence, breed a whole new generation of terrorists who otherwise might have been less receptive to joining groups like Al Qaeda. So the use of force can raise the costs that terrorists face, but this approach has high costs, direct as well as indirect, of its own. Overall, it's better to use carrots than sticks, Frey argues.

Why Haven't They Been Adopted?

If that's true, then why do governments resort to sticks rather than bring out the carrots? Partly, Frey argues, because governments don't want to be seen as weak. Better to act quickly and forcefully in response to a terrorist attack than to wait and consider what would be the most effective overall policy. (Indeed, even if governments do employ some of the policies that Frey suggests, they are unlikely to make them known, lest they be seen as appeasers. So while Frey is unable to offer many examples of his proposals working in practice — something that might help persuade skeptics — that doesn't necessarily mean that such examples don't exist.)

The carrot approach might also be unpopular because some of the key agencies within government — the military, the intelligence community, and the police — benefit from the use of force, Frey argues. They receive more resources and prestige. This argument is consistent with a standard "public choice" analysis: People in government are self-interested and enact policies that benefit them and their agencies. But is it right? In the case of U.S. antiterrorist policies, the facts don't seem to support this analysis.

There certainly were important public figures who favored going to war in Iraq, especially among civilian members of the Departments of Defense and State. But arguably the most prominent and articulate opponents of intervention were some of the very people who Frey states had an interest in going to war — military leaders, both active and retired. They argued that the direct costs of intervention were going to be larger than projected. They warned that intervention would not rid the Middle East of terrorists — that, in fact, it might increase their number. And, finally, they argued that it was hubristic to think that the United States could mold other countries in its image through the use of force.

This has significant implications for Frey's approach to fighting terrorism. It suggests that public opinion was more important in the drive to war than the self-interested behavior of government officials. The public supported military intervention, and got it. Polls suggest that a majority of people are having doubts now, and this, too, may affect the course of the war.

This means that government doesn't necessarily act according to a logic of its own, and that it's possible to implement noncoercive antiterrorist measures. This should gratify Frey. On the other hand, it means that he needs to convince a large share of the public that his approach has merit. He has his work cut out for him. It's one thing to believe that a specific military intervention is unwise or being prosecuted badly. It's quite another to believe that, as a general rule, carrots can be substituted for sticks. The former, no doubt, should be employed more widely. But the latter, for better or worse, are a tool that people will always be tempted to use. **RF**

DISTRICT ECONOMIC OVERVIEW

BY ROBERT LACY

The Fifth District economy expanded at a somewhat quicker pace in the third quarter of 2005. Services and retail activity was particularly brisk, boosted early in the period by accelerating automobile and light truck sales. Manufacturing output rose as well, with shipments and capacity utilization at least moderately higher during the quarter. Labor markets, however, were not as upbeat: Year-over-year payroll job growth eased and the District's unemployment rate inched up during the period.

Higher energy prices were much in the news in the third quarter but did little to slow consumer spending. Retail gasoline prices rose above \$3 per gallon in the wake of Hurricane Katrina in early September, and energy analysts warned that heating bills could be exceptionally high this winter. Still, consumer spending was steadfast despite the developments in the energy sector. Retail spending heading into the holiday sales season was generally good.

Economic Growth Continues

Services businesses generally reported strong sales gains in the third quarter. Retail sales rose throughout the period, and were especially strong in July and early August as attractive price

Economic activity rose at a somewhat quicker pace in the third quarter, though growth in employment moderated.

incentives spurred automobile and light truck sales. Higher fuel prices caused a run-up in costs for airlines and trucking firms in September and prompted fuel surcharges in a variety of businesses, but demand remained relatively strong for most types of services.

Residential real estate markets continued to flourish, and home prices rose at a rapid pace in many localities in the third quarter. According to the Office of Federal Housing Enterprise Oversight, house prices in the District of Columbia, Maryland, and Virginia were more than 18 percent higher than a year ago. Price appreciation and sales growth eased in some housing markets, though. The pace of construction also slowed: The number of residential

building permits issued in Fifth District states in the third quarter was 5.8 percent higher than a year earlier, down from a 10.5 percent pace in the second quarter.

Manufacturing shipments rose in the third quarter, as did new orders and capacity utilization, albeit at a moderate pace. But District manufacturers had to cope with surging petroleum-based raw materials prices and shortages of materials originating from the hurricane-damaged Gulf Coast region in September. While materials shortages soon eased, raw materials prices escalated through November.

Moderate Job Growth

Employment growth in the Fifth District for the first three quarters of 2005 was below the pace nationwide. Third-quarter payroll employment in the District was 1.2 percent higher than a year earlier, somewhat short of the 1.7 percent pace nationwide. Across the District, employment gains continued to be centered in services industries, while manufacturing employment generally declined. In North Carolina, the District's most industrialized state, there were 8,100 fewer manufacturing jobs in the third quarter compared to a year earlier.

District Income Growth Bests Nation's

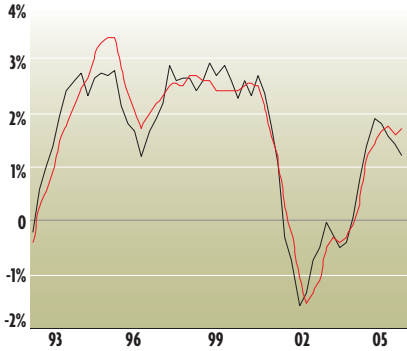
In contrast to employment growth, real personal income growth in the Fifth District continues to outpace growth nationwide. Income growth in the Fifth District was 3.3 percent above year-ago levels in the third quarter, surpassing the 2.4 percent U.S. pace. On a real per-capita basis, growth was strongest in Washington, D.C., with a year-over-year gain of 4.7 percent. Per-capita personal income in the District of Columbia was \$56,119 in the third quarter, tops in the Fifth District.

Economic Indicators

	3rd Qtr. 2005	3rd Qtr. 2004	Percent Change (Year Ago)
Nonfarm Employment (000)			
Fifth District	13,374	13,211	1.2
U.S.	133,961	131,731	1.7
Real Personal Income (\$bil)			
Fifth District	888.7	860.2	3.3
U.S.	9,176.5	8,959.5	2.4
Building Permits (000)			
Fifth District	63.8	60.3	5.8
U.S.	575.4	531.0	8.4
Unemployment Rate (%)			
Fifth District	4.9%	5.0%	
U.S.	5.0%	5.5%	

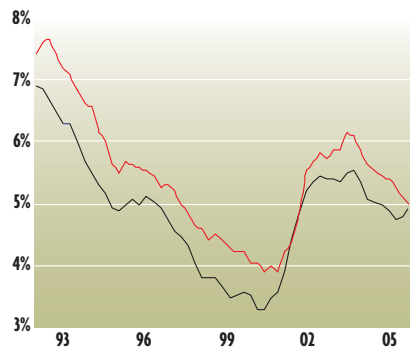
Nonfarm Employment

Change From Prior Year
First Quarter 1992 - Third Quarter 2005



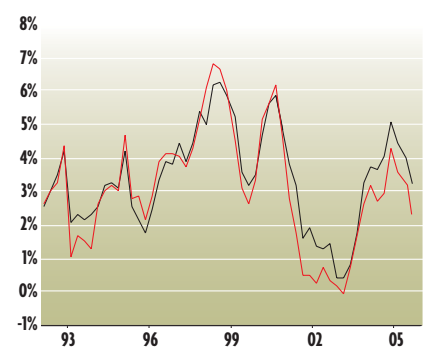
Unemployment Rate

First Quarter 1992 - Third Quarter 2005



Real Personal Income

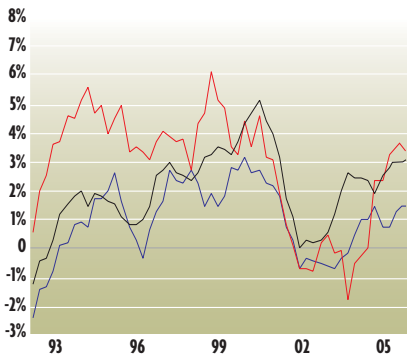
Change From Prior Year
First Quarter 1992 - Third Quarter 2005



— Fifth District — United States

Nonfarm Employment Metropolitan Areas

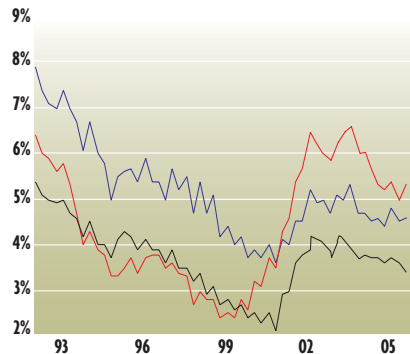
Change From Prior Year
First Quarter 1992 - Third Quarter 2005



— Charlotte — Baltimore — Washington

Unemployment Rate Metropolitan Areas

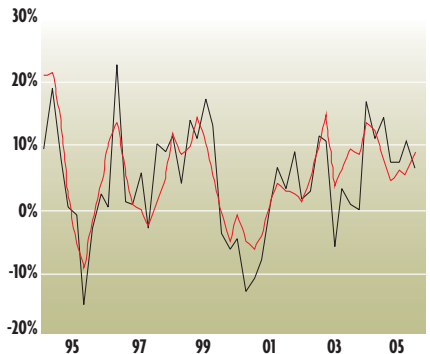
First Quarter 1992 - Third Quarter 2005



— Charlotte — Baltimore — Washington

Building Permits

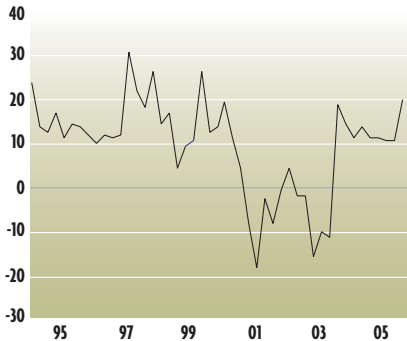
Change From Prior Year
First Quarter 1994 - Third Quarter 2005



— Fifth District — United States

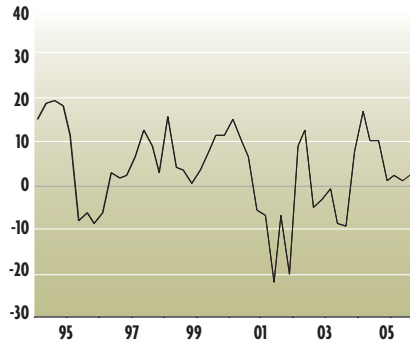
FRB — Richmond Services Revenues Index

First Quarter 1994 - Third Quarter 2005



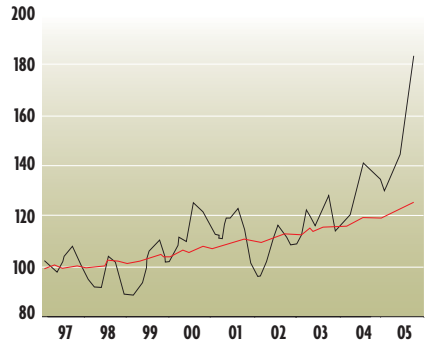
FRB — Richmond Manufacturing Composite Index

First Quarter 1994 - Third Quarter 2005



Washington D.C. — Baltimore Metro Area Consumer Price Index

January 1997 - September 2005



— Energy — All Items

NOTES:

1) FRB-Richmond survey indexes are diffusion indexes representing the percentage of responding firms reporting increase minus the percentage reporting decrease. The manufacturing composite index is a weighted average of the shipments, new orders, and employment indexes.
2) Metropolitan area data, building permits, and CPI are not seasonally adjusted (nsa); all other series are seasonally adjusted.

SOURCES:

Income: Bureau of Economic Analysis/Haver Analytics
Unemployment rate: LAUS Program, Bureau of Labor Statistics, U.S. Department of Labor, <http://stats.bls.gov>.
Employment: CES Survey, Bureau of Labor Statistics, U.S. Department of Labor, <http://stats.bls.gov>.
Building permits: U.S. Census Bureau, <http://www.census.gov>.

For more information, contact Robert Lacy at 804-697-8703 or e-mail Robert.Lacy@rich.frb.org.

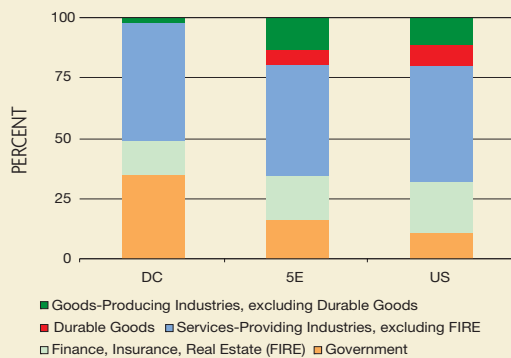
STATE ECONOMIC CONDITIONS

BY ANDREA HOLMES

District of Columbia

According to the recently released report on real gross state product (GSP) for 2004, the District of Columbia's economy expanded second fastest among Fifth District states. But the 2004 performance has not been repeated as strongly this year. While 2005 economic activity has expanded, third-quarter indicators were generally flat. Payroll and household financial conditions in the District of Columbia were little changed from the second quarter, and growth in the residential real estate markets expanded at a slower pace.

DC Sector Contribution to 2004 GSP



NOTE: Durable goods industries contribute only 0.2 percent of the District of Columbia's GSP, and as such, are not readily visible in the above chart.
SOURCE: Bureau of Economic Analysis

The latest estimates from the Bureau of Labor Statistics (BLS) survey of business establishments reported that third-quarter job numbers contracted 0.1 percent in the District of Columbia. Losses at education and health services, financial activities, and trade, transportation, and utilities establishments outweighed job gains in other services-providing sectors. Payroll activity on the smaller, goods-producing side of the economy also moderated somewhat. Construction jobs backed off 1.1 percent in the third quarter, perhaps reflecting softer demand for new housing.

In line with fewer construction jobs, District of Columbia third-quarter permit authorizations (sometimes viewed as an indicator of future activity) were also well below the year-ago level. Likewise, sales of previously owned homes contracted at a quicker pace for the third straight period. Rapid home price acceleration in the District of Columbia has likely contributed to the slowdown in home sales. The District of Columbia recorded a 21.5 percent jump in house prices in the third quarter — the largest increase districtwide.

The moderation recorded in the District of Columbia's housing markets does not appear to stem from a weakening of household conditions — third-quarter indicators of household

financials remained generally on track. Personal income expanded 0.3 percent, marking the second-strongest growth rate districtwide. The majority of the increase hailed from the government sector, with government earnings accounting for more than 45 percent of the third-quarter total.

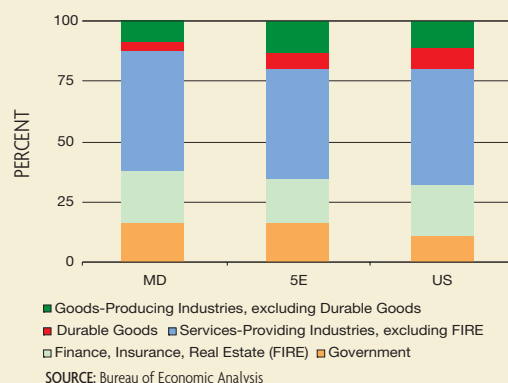
The importance of the government sector to the District of Columbia's economy was apparent in the recent measures of GSP. According to the U.S. Bureau of Economic Analysis (BEA), the government's contribution to 2004 economic growth in the District of Columbia amounted to nearly 35 percent.

Maryland

Double-digit growth in real estate activity and professional services were key factors in driving Maryland's GSP up 4.8 percent in 2004 and have helped pave the way for solid growth so far in 2005. In the latest readings, economic activity continued to gain ground in the third quarter. The most recent reports suggest that employment activity and household conditions in the state continued to improve, though growth in the residential real estate market moved ahead at a slower clip.

Maryland businesses boosted payrolls by 2.0 percent in the third quarter — the largest percentage increase recorded districtwide. Nearly all industry sectors tacked on jobs, with professional and business services and government establishments adding the most. The only sectors that didn't see a rise in employment were leisure and hospitality and manufacturing, where payrolls were trimmed by 0.3 percent and 2.2 percent, respectively.

MD Sector Contribution to 2004 GSP



SOURCE: Bureau of Economic Analysis

In line with rising payrolls, earnings rose in almost all of Maryland's industry sectors in the third quarter, boosting total personal income in the state. Compared to a year ago, third-quarter personal income expanded 3.4 percent, outpacing the nationwide gain of 2.4 percent.

The improving tone of the labor market was also reflected in Maryland's jobless rate. Large gains in the labor force in the third quarter held the jobless rate at 4.3 percent. By comparison, the national rate of unemployment stood at 5.0 percent.

Consistent with the nationwide trend, Maryland's real estate market advanced at a slower pace in the third quarter. Compared to the second quarter, new permit applications were fewer and existing home sales moved forward at a slower pace. Even with the decline in sales, however, the median price of an existing home was 19.3 percent higher in the third quarter than a year ago, marking the fifth-fastest increase nationwide.

Real estate-related activities are a vital part of the Maryland economy. As shown in the chart, output generated by finance, insurance, and real estate enterprises contributed nearly 22 percent to total 2004 GSP, a larger share than recorded in any other District jurisdiction.



North Carolina

Against the backdrop of a 4.4 percent increase in state economic output in 2004, North Carolina's economy continued to make headway through the third quarter of 2005. The labor and real estate markets advanced at a quicker pace, and nearly all indicators of household financial conditions improved.

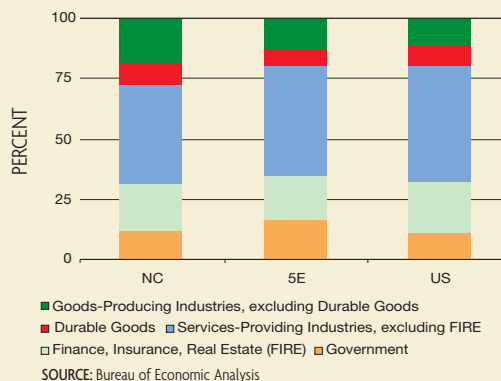
According to the BLS establishment survey, business hiring in North Carolina advanced by 14,600 jobs in the third quarter, the largest net gain districtwide. The professional and business services sector added the majority of new jobs, while the manufacturing sector trimmed the most — the 2.7 percent reduction in payrolls marked the largest quarterly loss in two years.

Despite continued job losses in the manufacturing sector, North Carolina's economy remains most dependent on non-durable manufactured goods among District states, with that sector accounting for 19 percent of 2004 GSP. Expansion in the sector has been sluggish though, contributing only one-tenth to total GSP growth in 2004.

In contrast, strong expansion on North Carolina's services side of the economy has helped keep household employment conditions bright. In the third quarter, the BLS household survey continued to suggest a generally upbeat tone. Though the jobless rate rose 0.4 percentage point to 5.6 percent — well above the national and districtwide rates — much of the gain was spurred by a 36,567 person surge in the labor force, the largest quarterly gain since early 2001.

Personal income is another telling measure of household financial conditions. Compared to a year ago, third-quarter personal income expanded 2.7 percent in North Carolina, just above the national growth rate of 2.4 percent.

NC Sector Contribution to 2004 GSP



Rising personal incomes and more moderate home price acceleration have led to sustained growth in North Carolina's residential real estate markets. Third-quarter existing home sales in North Carolina were 11.7 percent higher compared to year-ago levels and the number of new building permits issued expanded 6.9 percent over same period.

North Carolina's housing market has been buoyed by more moderate home price escalation in recent years than in other District states. The most recent data from the Office of Federal Housing Oversight reported that a median-priced home in North Carolina was only 6.9 percent more expensive than it was a year earlier. As such, the state ranked last districtwide and 37th nationwide in terms of annual home price acceleration.



South Carolina

South Carolina ranked 28th nationwide in terms of GSP growth in 2004. Despite the comparatively soft reading, however, the 2004 estimate marked the fourth straight year that the state's economic growth rate strengthened. Likewise, after getting off to a relatively slow start in 2005, economic activity in South Carolina has steadily gained momentum over the year. In the third quarter, labor market and conditions firmed further — and unlike activity in a number of District states — the housing market continued to advance steadily.

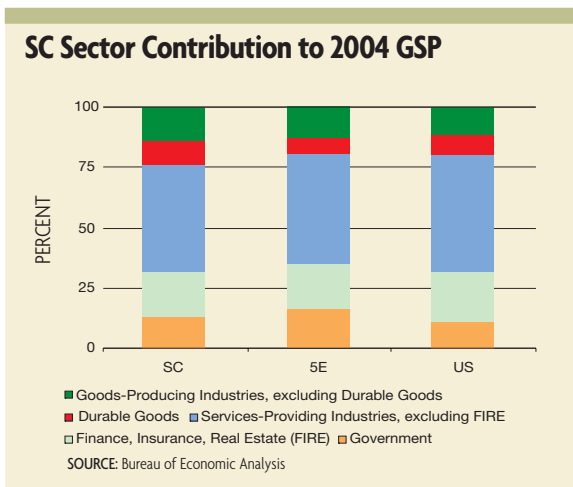
South Carolina payrolls rose 0.4 percent in the third quarter, a turnaround from the 0.7 percent contraction recorded a quarter earlier. On the services side of the economy, job growth was recorded in all sectors except government, which posted a modest loss. In contrast, all goods-producing sectors (natural resources and mining, construction, and manufacturing) saw employment declines. Though goods production has declined as a share of total economic output, it still plays a pivotal role in South

Carolina's economy — accounting for more than a quarter of the state's 2004 GSP of \$124 billion.

Outside of job growth at South Carolina businesses, indicators of household employment in South Carolina also perked up. The third-quarter jobless rate inched lower, dropping 0.1 percentage point to 6.3 percent — the lowest rate since late 2002.

In contrast to the turnaround in payroll and household employment conditions, measures of personal income in South Carolina softened in the third quarter. Personal income fell 0.1 percent compared to a quarter earlier, the second-weakest reading among District jurisdictions.

More positively though, the residential real estate market continued to gain ground in the third quarter, outpacing activity in most other District states. Third-quarter building permits were 23.5 percent higher over the year, and existing home sales posted an 18.1 percent gain, the strongest increase

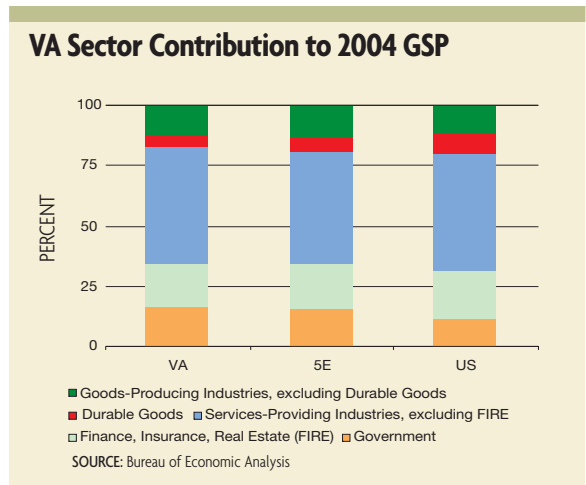


districtwide. The persistence of strong home sales growth could reflect the relatively slower appreciation of South Carolina's housing stock — the third-quarter 11.1 percent jump remained below the districtwide increase of 15.7 percent.

Virginia

In the third quarter, the BEA reported that the value of all goods and services produced in Virginia last year reached \$302 billion — the largest economy among District jurisdictions. Moreover, economic growth in Virginia outstripped that of all other District states in 2004 and ranked third nationally. With the groundwork already laid, the employment situation and financial conditions at Virginia households forged ahead in the third quarter. Activity decelerated in the real estate markets though, perhaps signaling a return to a more sustainable level.

Compared to the second quarter, Virginia businesses boosted payrolls by 1.6 percent, or 14,267 jobs, in the third



quarter. The bulk of the employment gains occurred on the services side of the economy, which according to the BEA, generated nearly 70 percent of total GSP in 2004.

The employment situation at Virginia households also remained upbeat — the jobless rate held firm at 3.6 percent, the lowest rate districtwide and more than a full percentage point below the national rate of 5.0 percent.

Robust economic growth and better employment prospects have helped boost incomes at Virginia households. In the third quarter, personal income expanded 0.4 percent, the highest growth rate districtwide.

In real estate markets, Virginia households and businesses trimmed activity from the elevated levels seen recently, as did businesses. At the household level, third-quarter sales of existing homes backed off 1.5 percent compared to a quarter earlier. And on the business front, applications for new building permits declined sharply. More telling, both measures came in below levels recorded a year ago, signaling the possibility that the real estate market is near its peak.

The trailing off of sales from their peak comes on the heels of a rapid acceleration of home prices in Virginia. According to the Office of Federal Housing Oversight, the median-priced home in Virginia was 18.7 percent above year-ago levels in the third quarter, ranking seventh nationally in terms of annual home price acceleration. Signs of a cooling market, however, were evident in this measure as well. Compared to the second quarter, home prices advanced at a slower pace, marking the first period of moderation in a year.

West Virginia

The U.S. Department of Commerce recently reported that West Virginia had the 43rd fastest-growing economy in 2004. Manufacturing remained the largest private sector segment of the economy, contributing 11.4 percent

to GSP. This sector, however, contributed the least to economic growth — contracting 0.5 percent in 2004 and dragging overall growth lower. Fast-forward to the third quarter of 2005 and the state seemed unable to shake off 2004's lackluster performance. Economic conditions in West Virginia appear to have retreated further, with third-quarter indicators of employment and household financial conditions weakening. Not all news was downbeat, though. Real estate activity, sustained by some of the lowest home prices in the nation, continued to move forward.

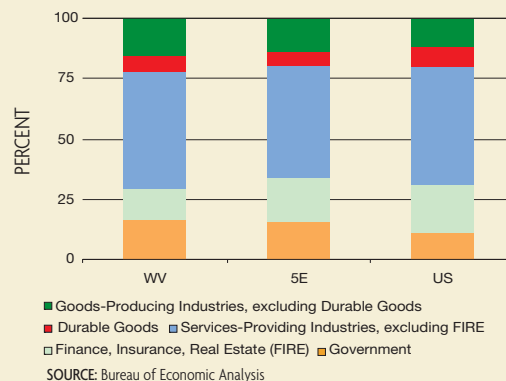
According to the BLS establishment survey, payroll employment retreated 0.7 percent in West Virginia during the third quarter, the weakest reading among District jurisdictions. Nearly all sectors trimmed jobs, with the largest losses recorded in manufacturing and leisure and hospitality.

The less upbeat tone was mirrored in the BLS survey of household employment. West Virginia's jobless rate moved 0.8 percentage point higher in the third quarter to 5.6 percent, coming in well above both the national and Fifth District averages.

The decrease in jobs coupled with an increase in unemployment partly explains West Virginia's somewhat muted income measures. Compared to a year ago, personal income expanded only 2.6 percent in the third quarter, the slowest increase districtwide.

Despite modest personal income growth, third-quarter home sales and new permit authorizations remained well above year-ago levels. Still though, the most recent data from

WV Sector Contribution to 2004 GSP



the Office of Federal Housing Oversight reported third-quarter home price appreciation of only 10.4 percent in West Virginia, the second-lowest growth rate districtwide.

Limited home price acceleration during the most recent boom may help insulate West Virginia homeowners should the market self-adjust. In addition, the state would be further cushioned as real estate-related business activities play a comparatively small role in West Virginia's overall economy. As shown in the chart, output generated by finance, insurance, and real estate enterprises contributed only 13 percent to total 2004 GSP, the smallest share recorded districtwide.

Behind the Numbers: Do Surveys Matter?

People who watch the U.S. economy rely on a number of indicators to help them understand how things are going. The problem with some of these indicators — especially regional ones like Gross State Products and manufacturing employment — is the lag time between the periods they measure and when they are released. That makes the Federal Reserve Bank of Richmond's manufacturing and retailing surveys, published on a monthly basis, especially valuable. The surveys provide information on business activity that might not have already shown up in other economic data. The Richmond reports are closely watched in large part because the composition of the Fifth District economy — with a good mix of manufacturing and services business — is similar to that of the broader, national economy.

The Richmond's manufacturing survey is distributed to about 200 manufacturing managers in the Fifth District during the second week of each month. Managers are asked whether their shipments, new orders, and employment increased, decreased, or didn't change over the past month. Other sections ask about inventory levels and price trends. The results are published in the form of a diffusion index, in

which "0" represents the level of business activity the previous month. Positive numbers, then, suggest growth and negative readings suggest that the level of activity decreased.

But how useful are these surveys in helping economic policymakers? After all, if the survey results are driven chiefly by factors that don't tell us much about where we are in the business cycle's two- to five-year fluctuations in output, employment, and income, then policymakers don't learn much that is helpful in making decisions about monetary policy.

So do the surveys matter? That's the question that Richmond Fed economists Raymond Owens and Pierre-Daniel Sarte try to sort out in a recent paper in the Federal Reserve Bank of Richmond's *Economic Quarterly*.

Their analysis demonstrates that most of the survey index's movements are directly tied to the overall business cycle, not extraneous factors like seasonal swings or long-term trends. That means when business managers respond to the Richmond manufacturing survey, they are essentially telling policymakers something about where the country is in the business cycle. For policymakers, that kind of information is priceless.

— DOUG CAMPBELL

State Data, Q3:05

	DC	MD	NC	SC	VA	WV
Nonfarm Employment (000)	681.7	2,576.0	3,894.9	1,832.9	3,644.4	743.4
Q/Q Percent Change	-0.1	2.0	1.5	0.4	1.6	-0.7
Y/Y Percent Change	1.6	2.1	1.1	0.1	1.3	0.9
Manufacturing Employment (000)	2.5	138.5	573.5	263.8	298.6	62.0
Q/Q Percent Change	5.4	-2.2	-2.7	-0.7	0.3	-6.2
Y/Y Percent Change	1.3	-3.3	-1.4	-2.0	-0.4	-1.2
Professional/Business Services Employment (000)	147.2	391.0	450.1	188.6	588.0	59.2
Q/Q Percent Change	0.9	2.9	6.7	3.0	0.2	6.3
Y/Y Percent Change	2.7	4.5	4.1	-2.5	1.0	1.7
Government Employment (000)	231.9	467.8	660.3	331.5	658.1	143.4
Q/Q Percent Change	2.9	2.5	2.3	-1.3	1.7	-1.1
Y/Y Percent Change	0.9	0.7	-0.1	0.0	0.9	-0.1
Civilian Labor Force (000)	299.6	2,944.3	4,342.8	2,075.6	3,935.0	797.8
Q/Q Percent Change	-0.7	2.3	3.4	1.5	3.0	2.5
Y/Y Percent Change	0.6	2.1	1.8	1.2	2.9	1.2
Unemployment Rate (%)	6.4	4.3	5.6	6.3	3.6	5.6
Q2:05	7.7	4.3	5.2	6.4	3.6	4.8
Q3:04	8.4	4.3	5.4	6.9	3.7	5.4
Personal Income (\$bil)	27.6	210.0	238.1	108.4	260.4	44.2
Q/Q Percent Change	0.3	0.3	0.1	-0.1	0.4	-0.2
Y/Y Percent Change	3.4	3.4	2.7	2.8	4.2	2.6
Building Permits	182	7,628	25,794	13,361	15,301	1,529
Q/Q Percent Change	-99.8	-48.3	-13.6	-18.3	-41.2	-4.1
Y/Y Percent Change	-45.7	2.6	6.9	23.5	-5.1	4.3
House Price Index (1980=100)	571.2	468.5	302.2	289.0	427.9	222.1
Q/Q Percent Change	21.5	17.4	7.9	11.1	18.2	10.4
Y/Y Percent Change	20.5	19.3	6.9	8.5	18.7	10.7
Sales of Existing Housing Units (000)	10.0	139.7	253.6	120.6	184.9	39.4
Q/Q Percent Change	-21.9	0.4	32.5	7.2	-1.5	-3.7
Y/Y Percent Change	2.0	-3.0	11.7	18.1	-3.6	5.1

NOTES:

Nonfarm Payroll Employment, thousands of jobs, seasonally adjusted (SA) except in MSA's; Bureau of Labor Statistics (BLS)/Haver Analytics, Manufacturing Employment, thousands of jobs, SA in all but DC and SC; BLS/Haver Analytics, Professional/Business Services Employment, thousands of jobs, SA in all but SC; BLS/Haver Analytics, Government Employment, thousands of jobs, SA; BLS/Haver Analytics, Civilian Labor Force, thousands of persons, SA; BLS/Haver Analytics, Unemployment Rate, percent, SA except in MSA's; BLS/Haver Analytics, Personal Income, bil.chn. 20005, BEA/Haver Analytics, Building Permits, number of permits, NSA; U.S. Census Bureau/Haver Analytics, Sales of Existing Housing Units, thousands of units, SA; National Association of Realtors®

Metropolitan Area Data, Q3:05

	Washington, DC MSA	Baltimore, MD MSA	Charlotte, NC MSA
Nonfarm Employment (000)	2,938.3	1,288.4	797.1
Q/Q Percent Change	0.8	1.4	-0.2
Y/Y Percent Change	2.9	1.4	3.1
Unemployment Rate (%)	3.4	4.6	5.3
Q2:05	3.6	4.5	5.0
Q3:04	3.7	4.6	5.3
Building Permits	7,822	2,490	6,094
Q/Q Percent Change	-80.1	-20.3	21.5
Y/Y Percent Change	-19.9	-0.9	3.6
	Raleigh, NC MSA	Charleston, SC MSA	Columbia, SC MSA
Nonfarm Employment (000)	268.8	281.6	345.1
Q/Q Percent Change	-0.4	1.2	-2.5
Y/Y Percent Change	0.6	2.5	0.6
Unemployment Rate (%)	4.5	5.2	5.5
Q2:05	4.3	4.8	5.3
Q3:04	4.2	5.5	5.9
Building Permits	1,186	2,618	1,846
Q/Q Percent Change	-12.7	9.5	-38.9
Y/Y Percent Change	-17.4	16.5	4.6
	Norfolk, VA MSA	Richmond, VA MSA	Charleston, WV MSA
Nonfarm Employment (000)	763.7	617.2	148.7
Q/Q Percent Change	2.0	-0.7	-4.9
Y/Y Percent Change	1.1	2.8	-0.1
Unemployment Rate (%)	4.2	3.8	5.0
Q2:05	4.1	3.7	4.9
Q3:04	4.1	3.9	4.5
Building Permits	2,582	2,666	82
Q/Q Percent Change	3.2	43.2	-79.6
Y/Y Percent Change	8.0	10.2	-16.3

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Protectionism's Dangerous Allure

BY DOUG CAMPBELL

Economists often sound insensitive when talking about international trade. The United States is losing tens of thousands of textile manufacturing jobs, putting many able-bodied citizens out of work. But economists assure us that, in the long run, there is no substitute for free markets and open competition across borders. It's all there in the theory of comparative advantage, which demonstrates that trade is mutually beneficial. If American workers aren't making fabric, that's because they're better at making more lucrative microchips — and now we can buy fabric at cheaper prices from overseas sources. If not microchips, then software. And so forth. Why do so many people — from all walks of life — fail to grasp these economic arguments?

In part, it's because those arguments aren't very comforting in the near term. In December, with the purchase of textile maker Dan River Inc. and the expected shipping of many of the company's remaining 1,100 local jobs overseas, economists were presented with another opportunity to sound indifferent to a region's pain. Southside Virginia used to be a textile boom area, with Dan River alone once employing more than 14,000 workers. Now, an Indian firm — Gujarat Heavy Chemicals Ltd. — has purchased Dan River's dwindling assets, less than two years after the Danville-based company filed for Chapter 11 bankruptcy protection.

There can be no sugarcoating the loss. Unemployment in Danville is 7.2 percent, already nearly twice the state average. Aging Dan River workers will find it difficult to secure new jobs that pay as well or with similar benefits. To them, comparative advantage is little more than a fancy theory, and free trade far from a good deal.

This is hardly a new trend. The Fifth District, along with the entire country, has watched textile and apparel jobs move to lower-cost venues such as Asia and Latin America. In the past decade alone, the United States has lost more than 909,000 textile and apparel industry jobs. Some industry representatives point out that the big drop-off started just after the adoption of NAFTA. With quotas for apparel and textile products now lifted among members of the World Trade Organization — including China — it's no surprise that the shifting continues. A lot of the upheaval is concentrated in the Southeast, home to most of this nation's textile and apparel jobs, with North Carolina accounting for the highest portion. Of course,

the prominence of textiles in the Southeast is a direct result of the industry's early 20th century shift from higher-cost locales in the Northeast.

Economists are not blind to all this. They just take these changes in context. Trade both creates and destroys jobs. But on balance, the overall U.S. economy would be much better off with fewer barriers to trade. In such a world, each nation can specialize in doing what it does best, be it sewing T-shirts or developing new gene therapies.

The failure of economists to convince people that removing trade barriers is a smart move has to do with the dispersed benefits and concentrated costs of liberal trade policies. The people of Danville bear, in the short term, a disproportionate amount of the pain in the transition from textile production to the provision of some other good or service. Their problems are large and easy to see — and will be well-documented this year as unemployment claims inevitably rise and workers seek new paychecks.

In contrast, you won't see headlines about gradually falling prices of T-shirts and other apparel, even

though lower prices can have a large aggregate positive effect on the economy. Nor will most people immediately understand that the departure of Dan River and similar companies will provide real incentives for people to obtain new skills that are valued in a changing economy, which ultimately will raise living standards. This disconnect helps explain why there is relatively little in the way of a groundswell for free trade. To economists, support for freer trade is almost universal. But among the public, skepticism remains widespread.

In matters of trade, it's a mistake to think of nations as enemies, with one country's gain another one's loss. It is equally a mistake to use protectionist policies as a way to postpone the expiration dates of some U.S. jobs. Doing so diverts resources from new, growing industries, and instead directs them toward keeping dying U.S. industries afloat — at least for a while.

None of which is immediate consolation to the people of Danville. But it's worth keeping at the forefront of the region's plans for economic development. We've said this before: Ultimately, the only protection a worker has in the labor market is cultivating valuable skills that many employers will bid for. The exit of Dan River is not so much about giving up as it is about moving on.

RF

It is a mistake to use protectionist policies as a way to postpone the expiration dates of some U.S. jobs.

The Other Road Rage

Everybody wants congestion-free roadways, but at what cost? We take a look at the economics of road building and the innovative solutions, some involving the private sector, that may soon gain traction in the Fifth District.

Antidumping

Even as the use of tariffs and quotas has declined, a relatively unheralded instrument of trade protection has been flourishing. Antidumping policy in the United States promises to shield U.S. manufacturers from unfairly priced imports. But many economists believe that such remedies have little to do with predatory pricing and end up hurting more domestic businesses than they help.

Boatbuilding

Boatbuilding remains a viable, if somewhat less economically important, industry in coastal North Carolina. We examine its unique place in the economy and how it aims to survive in the 21st century.

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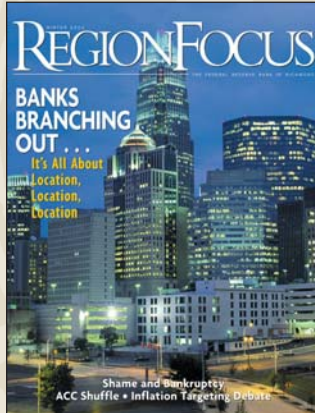
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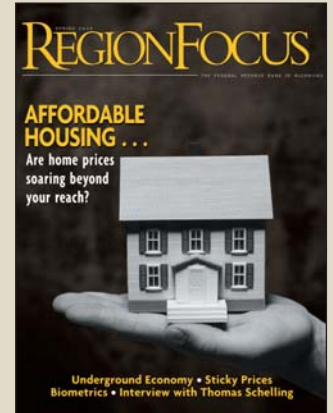
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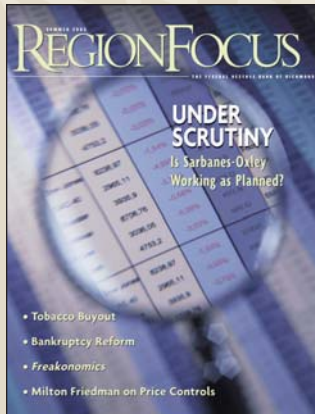
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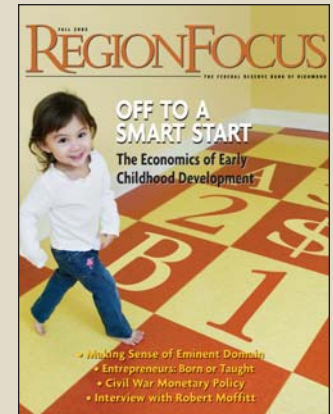
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