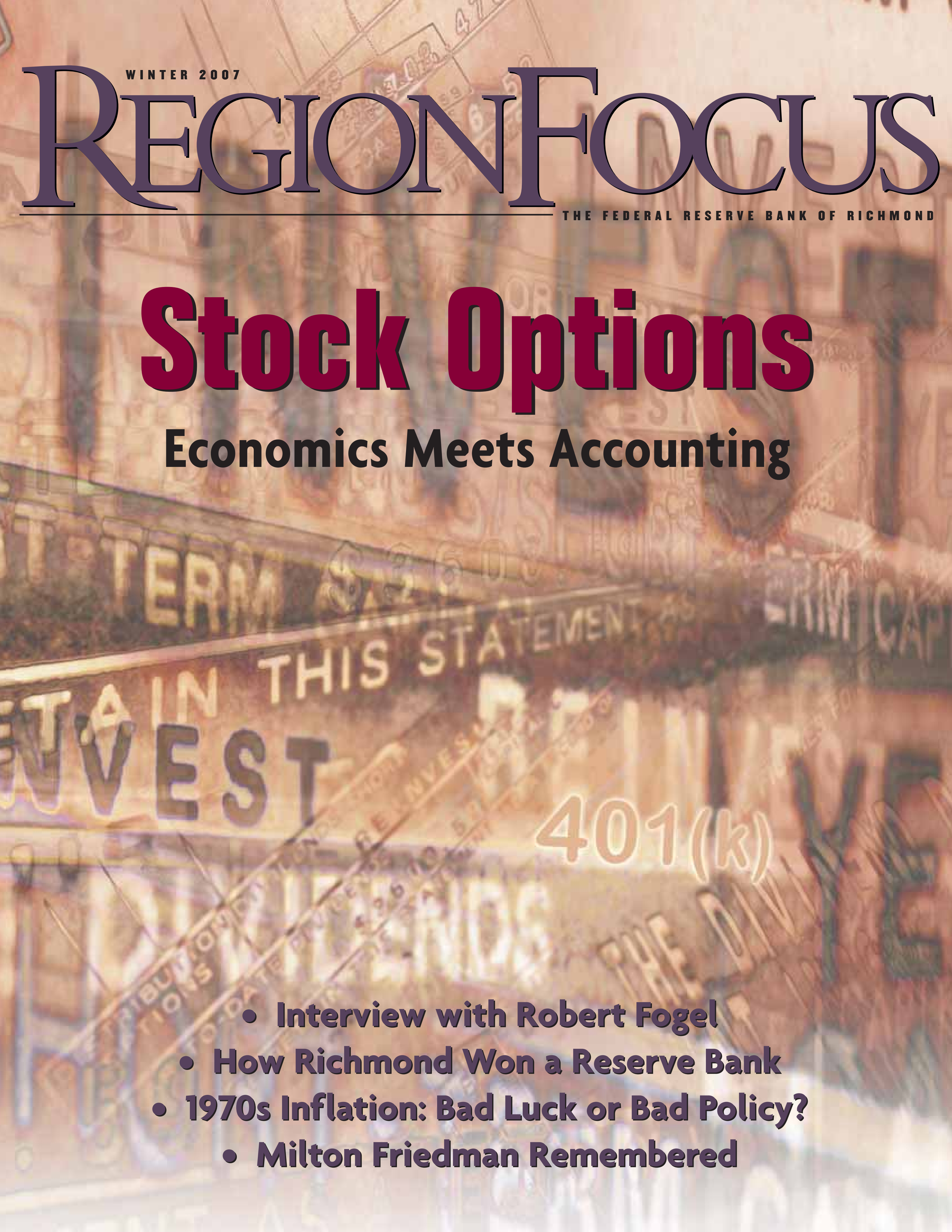
WINTER 2007

REGION FOCUS

THE FEDERAL RESERVE BANK OF RICHMOND



Stock Options

Economics Meets Accounting

- Interview with Robert Fogel
- How Richmond Won a Reserve Bank
- 1970s Inflation: Bad Luck or Bad Policy?
- Milton Friedman Remembered

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REGION FOCUS

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Policy Trumps Luck

In economic circles, the 1970s are known for the period's runaway inflation. As the story goes, Federal Reserve policymakers made all the wrong moves in attempting to rein in prices. It took the decisive actions of Fed Chairman Paul Volcker, who was willing to raise interest rates sharply in order to finally arrest inflation's rise in the early 1980s, ushering in the period known as the Great Moderation.

It's a good story, but it is not unchallenged. As Vanessa Sumo's article in this issue of *Region Focus*, "Bad Luck or Bad Policy?" describes, some economists have argued that both the Great Inflation of the 1970s and the Great Moderation of the 1980s and onward resulted not so much from unwise and then shrewd monetary policy, but rather from luck — first bad and then good. According to this argument, in the 1970s, the United States suffered two energy shocks, in 1973 and 1979, which sent the price of many goods skyrocketing; the Fed may not have made all the right moves, but it was essentially powerless to prevent inflation from rising. Then, in the 1980s, oil prices stabilized and subsequently fell. And in the 1990s, labor productivity increased, thanks largely to advances in technology such as computer power. This provided an environment in which the economy could grow relatively rapidly and inflation could fall steadily until it reached a level more in line with historical norms. In that light, some claim that the low inflation and the two relatively short and mild recessions we've experienced since then have had little to do with actions of the Federal Open Market Committee (FOMC). All this happened almost by accident, incidental to monetary policy.

Our article concludes that there is likely a role for both luck and policy in this story. There can be no question that the U.S. economy encountered problems as a result of the energy shocks of the 1970s, and that this complicated the mission facing the Federal Reserve. Likewise, subsequent productivity improvements have been a great boon to the economy and arguably made the Fed's job easier. But in both cases, the Fed was far from powerless. Fundamentally, it retained the power to achieve low and stable inflation. But before discussing the core issue of monetary policy more fully, let me turn to another significant development that has affected the U.S. economy recently: the productivity improvements that have resulted from financial innovation.

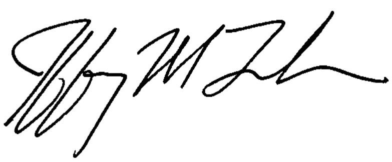
Something of a revolution in unsecured credit began in the 1980s and picked up steam in the 1990s. The same period saw advances in mortgage and home equity lending. Thanks to falling costs of computing and telecommunications, creditors became able to evaluate borrowers more efficiently and effectively. Thus, credit became more widely available, and on better terms, to more borrowers. Financial innovations also encompassed the world of high finance, with a host of new products coming to the wider market — derivative contracts, swaps, and securities backed by all sorts of assets.

What did all these innovations accomplish? They helped households smooth consumption and, by extension, contributed to economic growth by reducing the volatility of consumption relative to income and expense shocks. Moreover, financial innovation seems to have played a role in launching and sustaining the Great Moderation.

But as with our previous lessons, we must be careful not to draw overly broad conclusions. Yes, the fruits of financial innovation can be seen at the macroeconomic level in the form of reduced real volatility. Certainly, such "lucky" economic shocks make a difference in output. But the full story still must include a prominent place for monetary policy. Through its policy actions, only the FOMC can fundamentally control inflation — and in so doing, it can also foster an environment in which growth can occur.

During the 1970s, the economy and prices seemed to be at the mercy of energy shocks. But in my view, the damage need not have been nearly so great. Monetary policy during the 1970s was excessively loose. The resulting surge in overall inflation raised expectations of yet further inflation. The Fed accommodated energy price increases and let them pass through to the prices of other goods and services. Had we seen a more aggressive approach to confronting inflation, it is reasonable to believe that we would have achieved both lower inflation and faster economic growth.

In the debate over "luck vs. policy," place me firmly in the "policy" camp. Financial innovations and productivity improvements are important to economic growth. But these gains can easily be compromised by poor monetary policy. By keeping inflation low and stable, good monetary policy avoids the need for sharp movements in interest rates that can add to volatility in real economic activity. The improved economic performance of the last two and a half decades demonstrate the importance of the Fed's pursuit of price stability.



JEFFREY M. LACKER
PRESIDENT
FEDERAL RESERVE BANK OF RICHMOND

FEDERAL RESERVE

A Division of Power

BY CHARLES GERENA

During an intense four months in 1914, America's central bank took shape. How Richmond won a Reserve bank

April 2 had a special meaning for Richmonders in the years following the Civil War. It was that date in 1865 when Southern soldiers fled the Confederate capital as Union troops approached, setting fire to tobacco warehouses and bridges during their retreat. The ensuing conflagration and looting that followed the next morning left smoldering piles of rubble where newspaper offices, banks, and hotels once stood.

Almost a half century later, the date would bring a feeling of vindication to a city that spent decades recovering from that devastating fire and the economic upheavals of the Reconstruction era. On April 2, 1914, it was announced that Richmond would become one of 12 cities to serve as a base of operations for the Federal Reserve System.

The Fed's formation culminated years of debate over what kind of central bank the United States needed to avert liquidity problems and bank failures in the future. Should the Fed be governed by the private sector in association with government officials or by political appointees? Should the Reserve banks have a high level of autonomy or be mere branches of a powerful central authority? For various economic and political reasons, Congress decided on a regional approach with the Federal Reserve Act of Dec. 23, 1913.

That was only half the battle. For the next three months, the Reserve Bank Organization Committee made some tough choices on the number of Reserve banks, the boundaries of the districts that the banks would serve, and the headquarters city for each district. The latter task attracted formal petitions from 37 cities, including Baltimore; Washington, D.C.; Charlotte; Columbia, S.C.; and Richmond.

Every contender had its merits, its fierce supporters, its political levers. While Richmond was smaller in population compared with Baltimore or Washington, the city loomed large in the eyes of Southern businessmen. This was reflected in the flow of capital at the time. Richmond's national banks loaned $33.5 million to borrowers in 13 Southern states as of January 1914, more than any other community in the country — except New York — and four times greater than Baltimore and Washington combined. This historical connection likely gave the River City an edge in gaining a Reserve bank.

The Richmond Fed opened the doors to its first headquarters at 1109 East Main Street in November 1914, less than a year after the city's business leaders began their bid for a Reserve bank.

PHOTOGRAPHY: VALENTINE MUSEUM/RICHMOND FED ARCHIVES

The Conflict

The Reserve Act designated who would serve on the organization committee: Treasury Secretary William McAdoo, Agriculture Secretary David Houston, and Comptroller of the Currency John Williams. (Williams wasn't confirmed by the U.S. Senate until mid-January so he missed the early stages of the committee's work.) While all eyes focused on these men, the initial preparation of a districting plan fell to a group of experts led by Henry Parker Willis, an economist who helped Congress craft the Reserve Act and would later serve as secretary for the first Federal Reserve Board.

The committee's mandate was clear but the path to meeting that mandate was not. The only criteria were a few paragraphs in the enabling legislation.

For example, each Reserve bank district had to open with at least $4 million in paid-in capital from its member banks. That may not sound like much by today's standards, but the average resources of state and national banks in 1915 amounted to just $916,000 per institution. The Reserve Act required member banks to pay 6 percent of their resources into the new central bank, or $54,960 per institution based on the average capitalization at that time. So, it would take about 73 banks of average size to put a Reserve bank over the $4 million threshold.

That made drawing district lines tricky. Banking resources were concentrated in the Northeast, necessitating the division of the region into several smaller districts to prevent any one Reserve bank from commanding too much capital at the expense of other banks. The reverse was true on the West Coast — economic activity was spread out so the district boundaries had to be drawn as broadly as possible to ensure that each bank was large enough to serve its constituents.

In addition, there had to be at least eight Reserve bank districts, but no more than a dozen. Here, the tension between a centralized and a regional system of central banking reasserted itself.

Prominent bankers in large cities wanted the minimum number of districts, with New Yorkers advocating a Reserve bank in their city that controlled most of the Northeast and seven other banks with less power and geographic scope. They felt a dominant New York Fed was necessary in order to win the respect of the financial community abroad.

Businessmen in smaller and more rural communities who wanted their interests served by the nation's new central bank had the opposite view. They wanted as many Reserve banks as possible, evenly distributed throughout the country and roughly the same size. Advocates of this approach also included populists like William Jennings Bryan; Treasury Secretary McAdoo, who feared a dominant New York Fed would overshadow the other Reserve banks; and Henry Willis, who felt each Reserve bank needed to be strong and self-supporting.

Also, a regionally balanced central bank would be better positioned to address seasonal imbalances between supply and demand in regional capital markets. According to University of Idaho economists Jon Miller and Ismail Genc, rediscounting commercial paper was the primary tool of monetary policy, given the rigidities of using the gold standard to regulate the money supply. "At times of high loan demand, regional Reserve banks could accept commercial paper owned by member banks as collateral for loans to them to expand the reserve base," they wrote in a 2002 article.

Ultimately, neither side of the debate got everything they wanted. Twelve districts were drawn and the capital paid into the Federal Reserve System was divided as evenly as possible, but the New York Fed still ended up with more capital than the four smallest Reserve banks combined. The New York Fed wasn't as large as its supporters wanted — that would have resulted in one bank commanding about half of the system's total capitalization — but it still ended up being the largest and the most influential. Its vaults have held gold reserves for foreign countries since 1924, its president assumed a permanent spot on the Federal Open Market Committee in 1943, and its domestic trading desk has conducted the Fed's open market operations since the 1920s.

Finally, the Reserve Act required that "districts shall be apportioned with due regard to the convenience and customary course of business." Railroad and telegraph lines had to connect each Reserve bank city with the communities it served so that checks could be delivered for clearing, member banks could present their collateral in person for loans of reserves, and bank employees could keep abreast of credit conditions.

At the Reserve Bank Organization Committee's first official meeting on Dec. 26, 1913, McAdoo and Agriculture Secretary Houston decided to focus on three factors when choosing a Reserve bank location: geographical convenience to member banks, the industrial and commercial development needs of communities within a district, and the established custom and trend of business.

"In laying out the districts and establishing the headquarters for Reserve banks, every effort will be made to disturb as little as possible existing conditions, and to promote business convenience and normal movements of trade and commerce," noted McAdoo and Houston in a statement released the next day. "While the committee appreciates the local pride and sentiment which are prompting many cities to urge their claims, [it must arrive] at sound conclusions through consideration of fundamental and vital factors."

The Prize

Even before the organization committee officially began its work, cities began petitioning for a Reserve bank. "Reserve cities are springing up all over the United States," Houston lamented to President Woodrow Wilson in a letter sent three days after the committee's initial meeting. "Certainly nobody could have imagined that so many [cities] had strategic locations."

Winning a Reserve bank was seen as good for business, though its precise economic impact was unclear. According to David Hammes, an economist at the University of Hawaii at Hilo, the responsibilities of the Federal Reserve System weren't fully known. "Nobody knew what was being created, not even the people on the committee," Hammes says. Some businessmen confused the role of the Reserve banks with commercial lenders.

Hammes adds, Uncle Sam didn't have the local presence and economic impact that it has today. Therefore, the creation of a regionally oriented central bank represented one of the first federal projects of national scope, promising to bring some form of government employment to communities, though the magnitude was still to be determined.

Finally, having a Reserve bank nearby would provide a convenient source of coin and currency, check handling, and other services to commercial banks. Among other things, this was expected to benefit firms involved in correspondent banking, which encompasses a variety of services that one bank provides to another bank, such as payments processing and foreign currency settlement.

During the selection process, McAdoo pointed out that the location of a Reserve bank in a city wouldn't be as important to their economic development as many assumed. In retrospect, it is possible that access to the Fed's efficient check clearing and discount window services indirectly helped businesses in the immediate vicinity of a Reserve bank. However, it is equally possible that the Reserve bank cities were already progressing more than other locales, which is why they were chosen.

In Richmond's case, its selection as a Reserve bank site was credited for elevating its status as a regional financial center. The city also had a lot going for it economically in the early 20th century.

Despite the turmoil of the Civil War and Reconstruction, Richmond remained a center of trade and finance in the "Old South." James Dooley, a wealthy railroad executive, described the city in this manner in a letter to Comptroller Williams. "Richmond is still to all intents and purposes the capital of that great division of the United States which lies between the Atlantic Ocean and the Mississippi, south of the Mason and Dixon's line," Dooley wrote. "She is the capital city of their business, the capital city of their banking, the capital city of their affections." Washington and Baltimore both had commercial ties to the South and retained many of its cultural traditions. But Richmond was more closely identified with the region.

Also, goods and capital in the South Atlantic tended to flow from south to north. Therefore, a Reserve bank in Richmond would be able to accommodate those regional flows and still be within reach of the Northeast's economic centers.

The Campaign

Even with these advantages, Richmond initially wasn't a contender for a Reserve bank, according to a book by Henry Willis in 1923 on the central bank's history. "In none of the preliminary surveys of the situation was the establishment of a bank at Richmond, Va., ever seriously considered," he wrote.

Willis himself considered a Richmond Fed "unnecessary" since Reserve banks in Atlanta and Philadelphia would be accessible to most of the Southeast and Mid-Atlantic. "He thought he had the Eastern Seaboard covered," Hammes notes, so having a Reserve bank in Richmond "didn't solve an economic problem."

Others believed that if the East was to be divided into multiple Reserve bank districts, Baltimore or Washington were better suited for a bank headquarters.

The Maryland Bankers Association and other trade groups supported Baltimore for several reasons. The port town handled a large volume of foreign trade, plus it was a center of domestic trade in the South Atlantic region. Supporters argued that the extent of Baltimore's trade within the region wasn't fully reflected in clearinghouse data since a "tremendous volume" of transactions was handled by jobbing houses and manufacturing plants.

Bankers and businessmen in nearby states said they had close financial ties to Baltimore and wanted to expand them. John Mayo, a Kentuckian who helped develop the state's coal and timber resources, was one of them. "Baltimore has lent us money for the development of our resources when we could not get it anywhere else and when New York turned us down," he said in a *Baltimore Sun* article. "If our paper is to be rediscounted, we want it held in a city in which we feel at home…"

The Washington Clearing House Association and other organizations believed their hometown deserved a Reserve bank because of the city's prominence as the seat of the federal government. Also, the bank would be near the Treasury Department and the Federal Reserve Board that was designated to manage the new central bank.

"If one of such banks be located in Washington directly under the vision of the Federal Reserve Board, that supervisory authority can watch … the work that is being carried on, note how the bank serves the purpose for which it is intended, and decide from personal contact and observation what rules and regulations are needed to bring all such banks to a high state of efficiency," noted Henry McKee of the Clearing House Association in his testimony to the Reserve Bank Organization Committee.

Oliver Sands, a prominent Richmond banker, initiated that city's lobbying efforts on Dec. 29, 1913, less than a week after the Reserve Act was enacted. He called a meeting of local banks eligible for Federal Reserve membership to discuss the idea of having a district headquarters in Richmond. Later that day, the Business Men's Club met to discuss the matter.

Both groups agreed to pursue a Reserve bank, calling on representatives from the private and public sector to form a joint "Committee on Locating a Federal Reserve in Richmond." The committee coalesced two days later, with Sands serving as the chairman.

A corps of stenographers and administrative assistants worked from a conference room at the Business Men's Club to gather information and send promotional literature to communities throughout the South Atlantic. Teams of volunteers also toured the region to convince local bankers. George Seay, who worked for the joint committee as a consultant and would later serve as the first leader of the Richmond Fed, gave several talks during an 11-day tour of the Carolinas.

Richmond managed to win over many Carolinians, including the president of the North Carolina Bankers Association and the former mayor of Charleston, S.C. The support wasn't unanimous, however. Some Tar Heels wanted a Reserve bank in Charlotte, while others in the Palmetto State preferred Columbia. Eventually, both cities mounted their own campaigns.

West Virginians were torn. Many bankers in the Mountain State felt more closely aligned with their neighbors in Ohio and Pennsylvania than with Virginia and other South Atlantic states. Wheeling, W.Va., bankers wanted to be included in a Reserve bank district along with Pittsburgh, a city that it had economic ties with. In January 1914, a poll of state and national banks in West Virginia revealed a preference for a Reserve bank in Pittsburgh or Cincinnati; Baltimore was also a popular option, while Richmond was the first choice of only 17 bankers.

Meanwhile, McAdoo and Houston had to act quickly. The Reserve banks were to be open for business by Nov. 16, 1914, less than a year after the Reserve Act was enacted. So, during six weeks in January and February, the gentlemen and a small entourage visited 18 cities on a highly publicized fact-finding mission, starting in New York City and ending in Cleveland. During their cross-country travels, a stenographer recorded more than 5,000 pages of testimony from more than 300 witnesses.

Representatives from Virginia and the Carolinas traveled to the nation's capital on Jan. 15 to present Richmond's case. Several hundred strong, the group greatly outnumbered other delegations from Baltimore, Charlotte, and Columbia which crowded into Williams' office at the Treasury Department during three days of hearings in Washington. (Williams, who was the assistant Treasury secretary at the time, did not stay for the hearings since he wasn't yet confirmed as Comptroller of the Currency.)

Seay presented his brief, prepared in just 18 days, outlining why Richmond should have a Reserve bank. The thoroughness of the stat-heavy brief, as well as of follow-up documents submitted about a month later, reportedly impressed McAdoo and Houston. Backers of a Reserve bank in Charlotte and Columbia were also apparently swayed by Seay's arguments, which were published in a bound volume and widely circulated. Those cities' campaigns fizzled in the face of growing support for Richmond.

The Fallout

Comptroller Williams joined McAdoo and Houston to work on the committee's plans for the rest of February and all of March. On April 2, 1914, they announced the fruits of their labor.

At the close of business that day, a crowd gathered at the Richmond offices of John L. Williams, a prominent

Popularity Contest

When the Reserve Bank Organization Committee wanted to take the pulse of the banking industry in 1914, there were no toll-free numbers that bankers could call or Web-based surveys they could answer. Instead, the Treasury Department mailed card ballots to each of the 7,471 national banks that had formally accepted the terms of membership in the new central bank system. The ballot asked for a first, second, and third choice for the location of a Reserve bank that bankers preferred to be associated with. "The ballots were gathered prior to designation of any district boundaries, so banks were unconstrained in their choice of cities," noted University of Hawaii at Hilo economist David Hammes in a September 2001 article in *The Region*, published by the Minneapolis Fed. "Comments by committee members in the various cities indicate that they had access to the results of the balloting prior to both the completion of their tour and their deliberations," which ended on April 2, 1914, with their announcement of the Reserve bank district boundaries and headquarters cities.

In a statement released eight days later in defense of its decisions, the committee members noted that bankers in North Carolina and South Carolina didn't want to be aligned with a Reserve bank located to their south or west. Instead, Carolinians preferred Richmond, which was the obvious favorite of Virginian bankers.

Not surprisingly, bankers polled in the District of Columbia and Maryland wanted a Reserve bank in Washington and Baltimore, respectively. But the committee members chose not to locate a bank in one of those cities, in part, because either would have been too close to the Philadelphia headquarters of the Third District. In addition, "the industrial and banking relations of the greater part of the district were more intimate with Richmond than with either Washington or Baltimore," they wrote in their statement.

South Carolina's capital city, Columbia, was the first choice of 28 national banks in the Palmetto State versus 11 for Richmond. But when the votes were added up, the latter city came out on top by garnering more second-choice votes: 27 for Richmond versus five for Columbia. Richmond also received far more first- and second-choice votes than Baltimore, Washington, or Charlotte from banks in North Carolina and Virginia. Baltimore did garner the most second-choice votes in West Virginia, placing it behind Pittsburgh in the final tally.

The views of West Virginia's bankers were especially divided, according to the committee's statement. So, the Northern Panhandle counties of Marshall, Ohio, Brooke, and Hancock were placed in the Fourth District, where they had business ties to the cities of Cincinnati and Pittsburgh. Those who had wanted to be associated with a Reserve bank in either of those cities, however, were still disappointed because the district's headquarters was located in Cleveland. (Pittsburgh and Cincinnati were later chosen as branch locations for the Fourth District.) The rest of West Virginia ended up in the Fifth District.

— Charles Gerena

banker, to await news from his son, the comptroller. Richmond's mayor and Virginia's governor anxiously waited with local bankers and businessmen to hear the announcement.

E.L. Bemiss, comptroller Williams' brother-in-law, kept his ear to the phone "and conversation fell to a whisper," according to a news report in the *Richmond Times-Dispatch*. Three men stood by a map of the United States to trace the boundaries of the Reserve bank districts as they were announced.

Finally, the call came from Comptroller Williams at 6:30 p.m. Bemiss relayed every word as Williams announced the 12 Reserve bank districts and boundaries one by one. "There was a dramatic and intense moment as the list of Reserve Bank cities and their regions came over the wire," the *Times-Dispatch* described. "When Richmond's name was called, bank presidents grasped hands and held them while they cheered together. Soon messenger boys were struggling into the crowded rooms with telegrams of congratulations from all sections of the country."

Richmonders celebrated as if they had gained a major league baseball team or the Summer Olympics. The next evening, the upscale Jefferson Hotel hosted a mass meeting and buffet dinner sponsored by the local chamber of commerce.

Elsewhere, though, the selection of Richmond and other Reserve bank cities wasn't as well received. New York, Chicago, St. Louis, and San Francisco were obvious choices for Reserve banks. They were centers of business and finance, had large populations, and were designated under the National Bank Act of 1864 as cities where national banks had to maintain reserves equal to a percentage of their deposits. Other choices were less obvious and subject to question. Baltimore and Washington, D.C., were clearly disappointed. So, too, were New Orleans and Denver. City leaders in both towns thought that they were deserving of a Reserve bank. Denver, in particular, questioned the wisdom of placing a Reserve bank in Kansas City, giving Missouri two banks.

The Reserve Bank Organization Committee offered a general explanation of how it drew district lines and selected headquarters cities, from the ability of a Reserve bank to assist businesses in its district to the district's economic track record and future prospects. Still, accusations flew of committee members playing politics.

Several Reserve bank cities had ties to high-level members of the Democratic Party, which was reinvigorated after taking control of Congress in 1910 and the White House in 1912. For example, Rep. Carter Glass, chairman of the House banking and finance committee, President Wilson, and Williams had strong Virginia connections and played pivotal roles in the formation of the Federal Reserve System. Glass, in particular, played a major role in crafting the Reserve Act and ushering it through Congress.

For several days, lawmakers on Capitol Hill debated the validity of the organization committee's choices. Glass gave an impassioned speech on April 8, 1914, defending Richmond's selection and the committee's motives.

"The business of the national banks in Virginia, including Richmond, is far ahead of the business of the national banks of Maryland, including Baltimore, or any other of the five states embraced in [the Fifth District]," he argued. As of Jan. 13, the capital and surplus of Virginia's national banks amounted to \$32.9 million, compared with \$31.3 million in Maryland, \$18 million in West Virginia, \$13.3 million in North Carolina, \$12.6 million in the District of Columbia, and \$10 million in South Carolina.

The organization committee eventually answered its critics by issuing another statement on April 10. Committee members argued that they wanted to choose cities which were growing in importance. Richmond's national banks were the largest source of loans, outside of New York, for businesses in the South. Also, they held more deposits from the region's banks than Baltimore or Washington, even though the latter were among the cities where banks had to park their reserves.

To provide further justification for its decisions, the committee released the results of a nationwide poll of 7,471 national banks. The poll was likely taken because many bankers had opposed the creation of the Fed, so the committee members wanted to be sure they felt included in the process.

The organization committee closely followed the preferences

Poll of National Banks, Top-Five Preferences for Reserve Bank Cities by State

MD	1st & 2nd Choice Votes	NC	1st & 2nd Choice Votes	SC	1st & 2nd Choice Votes
Baltimore	97	Richmond	57	Richmond	38
Philadelphia	25	Charlotte	26	Columbia	33
Washington	25	Baltimore	23	Baltimore	6
New York	15	Washington	7	Washington	3
Pittsburgh	6	Philadelphia	3	Charlotte	3

VA	1st & 2nd Choice Votes	WV	1st & 2nd Choice Votes	D.C.*	1st & 2nd Choice Votes
Richmond	104	Pittsburgh	54	Washington	12
Baltimore	58	Baltimore	53	Baltimore	10
Washington	45	Cincinnati	39	New York	1
New York	7	Richmond	28	Philadelphia	1
Philadelphia	7	Washington	13		

*Only four cities in total received votes from national banks in the District of Columbia.

SOURCE: Reserve Bank Organization Committee, 1914 expressed by those surveyed — 11 out of the 12 cities that garnered the most support were selected as Reserve bank cities. Cleveland got the nod instead of Cincinnati or Pittsburgh, both of which were the preference of banks in the Fourth District.

Unmoved by the organization committee's assertions of objectivity, protests continued over Richmond's selection. The mayor of Baltimore and Maryland's governor led a massive demonstration at a downtown theater on the evening of April 15. More than 3,000 people attended, lining up in the pouring rain from the time the doors were opened until well after the meeting's start.

While other rivals eventually accepted the Reserve bank plan, Baltimore didn't back down. On April 29, the Regional Reserve Bank Committee of Baltimore asked the organization committee to reconsider and delay the formation of the Richmond Fed pending an appeal to the Federal Reserve Board. When the organization committee refused to do either, Baltimoreans crafted a detailed brief and sent it directly to the newly appointed Reserve Board on Sept. 11, 1914.

The brief argued, among other things, that Baltimore was a natural point of trade and its total banking resources far exceeded Richmond when taking into account the capital of the city's trust companies and mutual savings banks. In a formal rebuttal, George Seay pointed out that trusts were unlikely to join the Federal Reserve while mutual savings banks couldn't join, so their resources shouldn't have been counted. (This might have skewed the results of the poll as well since only Federal Reserve member banks were sent ballots.)

Despite these efforts, Baltimore lost its bid for a Reserve bank when the U.S. attorney general ruled in April 1916 that the Federal Reserve Board didn't have the authority to tinker with the locations of Reserve banks. Less than two years later the city did get a branch office that has grown into the eighth-largest check processor for the Federal Reserve System, handling 620 million checks in 2005.

The Legacy

Were the organization committee's decisions politically motivated? "The key role played by Virginians in devising, legislating, and ... implementing the new system no doubt provided encouragement" to Richmond's boosters, wrote James Parthemos, former director of research at the Richmond Fed, in a 1991 article for the bank's *Economic Review*.

However, Parthemos didn't think politics played a decisive role. "That the Richmond leaders were not prepared to count on political favoritism is indicated by their retention at some early stage of two of the nation's highly regarded professional banking consultants to evaluate the case for locating a Reserve bank in Richmond," he noted.

If the organization committee was politically motivated, then the choices for Reserve bank cities initially suggested by Henry Willis in a confidential report to the committee would have differed significantly from the committee's final plan, assuming that Willis wasn't merely telling the committee what it wanted to hear. In fact, there were only two differences — Willis selected Portland and Cincinnati, while the committee chose Richmond and Dallas.

Several researchers have found that the organization committee's decisions were likely based on economics, not just politics. For example, economist Michael McAvoy at the State University of New York at Oneonta compared a decisionmaking model based on economic factors with a model based on political preferences. He determined that the former was a better predictor of what the committee members agreed upon.

"The [organization committee] selected the proper 12 FRB locations based upon bankers' preferences, city population, [banking system] capital growth, and population growth," McAvoy described in a July 2006 article. "Given these objective criteria, the [committee] likely maximized social welfare rather than its own."

People have continued to push for some changes — a branch of the Richmond Fed opened in Charlotte in December 1927 after years of lobbying led by a local banker, while bankers and local government officials in Washington tried and failed to get a branch for their city in the 1970s. And, economists Miller and Genc, among others, have proposed reevaluating the district boundaries to better reflect regional economic relationships.

Still, as the saying goes, the proof of the pudding is in the eating. The operational structure of the Federal Reserve System has persisted through two World Wars, 17 recessions, and 16 U.S. presidents. **RF**

Readings

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JARGON ALERT

Pareto Efficiency

BY MEGAN MARTORANA

Imagine you and a friend are walking down the street and a $100 bill magically appears. You would likely share the money evenly, each taking $50, deeming this the fairest division. According to Pareto efficiency, however, any allocation of the $100 would be optimal — including the distribution you would likely prefer: keeping all $100 for yourself.

Pareto efficiency says that an allocation is efficient if an action makes some individual better off and no individual worse off. The concept was developed by Vilfredo Pareto, an Italian economist and sociologist known for his application of mathematics to economic analysis, and particularly for his *Manual of Political Economy* (1906). Pareto used this work to develop his theory of pure economics, analyze "ophelimity," his own term indicating the power of giving satisfaction, and introduce indifference curves. In doing so, he laid the foundation of modern welfare economics.

Because the two individuals in the opening example will not lose any of the money they originally held, they cannot end up worse off than they started. Any additional amount of money that they receive will make them better off. If one individual keeps all $100, the other will be as well off as he was before the money appeared. Whether the money is split evenly or one individual keeps more than the other, Pareto efficiency is achieved.

Consider another example: the sale of a used car. The seller may value the car at $10,000, while the buyer is willing to pay $15,000 for it. A deal in which the car is sold for $12,500 would be Pareto efficient because both the seller and the buyer are better off as a result of the trade. In this case, they are better off by the same amount: $2,500. However, any price between $10,000 and $15,000 is Pareto efficient because the seller receives more value in money than the value he places on the car, and the buyer values the car more than the money he pays for it.

Pareto efficiency has applications in game theory, multicriteria decisionmaking, engineering, and many of the social sciences. It is a central principle in economics.

In general, an economic allocation problem has several possible Pareto efficient outcomes. In the marketplace, the competitive equilibrium is typically included among them. A major drawback of Pareto efficiency, some ethicists claim, is that it does not suggest which of the Pareto efficient outcomes is best.

Furthermore, the concept does not require an equitable distribution of wealth, nor does it necessarily suggest taking remedial steps to correct for existing inequality. If the incomes of the wealthy increase while the incomes of everyone else remain stable, such a change is Pareto efficient.

Martin Feldstein, an economist at Harvard University and president of the National Bureau of Economic Research, explains that some see this as unfair. Such critics, while conceding that the outcome is Pareto efficient, might complain: "I don't have fewer material goods, but I have the extra pain of living in a more unequal world." In short, they are concerned about not only a person's absolute position but also his relative position, and argue that, as a result, Paretian analysis has little to offer.

Feldstein rejects this argument and maintains that Pareto efficiency is a good guiding principle for economists, even if some actions that promote Pareto efficiency lead to increases in income inequality. Instead, Feldstein argues that we should focus on poverty, and to do this we should not stifle changes that would increase the total economic pie just because they would also produce outcomes that would initially increase inequality.

In general, rich societies can more effectively deal with such problems than poor ones. For instance, would you rather live in a country that has almost perfect income equality but is desperately poor or one that has quite a bit of income inequality but is rich enough to help out its most unfortunate citizens? Most people would choose the latter.

That said, Pareto efficiency may not be the only benchmark that a society may wish to use in choosing between alternative public policies. It can be a very helpful guide — and, indeed, has enriched economic analysis a great deal — but as Pareto himself wrote, "Political economy does not have to take morality into account. But one who extols some practical measure ought to take into account not only the economic consequences, but also the moral, religious, political, etc., consequences." **RF**

ILLUSTRATION: TIMOTHY COOK

The Next Age of Globalization

BY CLAYTON BROGA

By now "offshoring" has become almost a household term in the United States. Jobs that used to be performed on these shores increasingly are shifting overseas — to China, India, and numerous spots in Latin America. It is a simple matter of cost savings: Companies take advantage of cheaper labor by substituting foreign workers for U.S. workers.

The loss of U.S. manufacturing and service jobs due to offshoring is highly visible, leading many to call for trade restrictions. But despite the political uproar, the economic theory behind offshoring remains sound. Ultimately, both foreign nations and the United States ought to benefit from trade, whether in goods or labor. Low-cost nations gain jobs while U.S. consumers gain lower prices. The United States can then build on its comparative advantage in high-value products and services, perhaps boosting productivity and growing the overall economy.

"Offshoring: The Next Industrial Revolution?" By Alan S. Blinder. *Foreign Affairs*, March-April 2006, vol. 85, no. 2, pp. 113-28.

Of course, such a transition can be painful, and it is by no means immediate. In "Offshoring: The Next Industrial Revolution?" Princeton University economist and former Federal Reserve Governor Alan Blinder takes a fresh look at offshoring and forecasts its future effects on the U.S. labor market. His main contribution is to argue that highly educated workers are not necessarily the answer to survival in the 21st century. Rather, the United States needs an education system that produces a work force geared to "personal service" jobs.

In the first Industrial Revolution, the U.S. work force shifted from agriculture to manufacturing. The second Industrial Revolution was characterized by U.S. jobs shifting from manufacturing toward services, though manufacturing remains an important part of the American economy. During these periods, only items "that could be put in a box" were considered tradable. Today, however, many things that were considered nontradable are becoming tradable as a result of improving technology and transportation. Blinder believes this marks the early stages of a third Industrial Revolution.

While this observation is not particularly unique, Blinder provides some novel ideas about how the United States ought to respond. The traditional remedy for coping with offshoring has been "more education and a general 'upskilling' of the work force." The United States' comparative advantage is increasingly in services, generally requiring highly skilled workers. But Blinder argues that the jobs threatened by offshoring today cannot be divided conventionally between jobs that require high levels of education and jobs that do not. As a result, upskilling the work force will not necessarily slow the movement of jobs overseas. Instead, the key determinant of a job's offshoring vulnerability is whether it is impersonal or personal, not low- or high-end. Typists, security analysts, manufacturing workers, accountants, and computer programmers are open to offshoring; taxi-drivers, airline pilots, construction workers, teachers, and nurses are likely not.

The economic effect of offshoring is impossible to ignore. Blinder predicts 28 million to 42 million current U.S. service sector jobs *could* logically be threatened by foreign competition. At the same time, he warns against attempts to halt offshoring. Efforts to protect American industries will not only fail, they will also be costly to the world economy. He says that "the world gained enormously from the first two industrial revolutions, and it is likely to do so from the third — so long as it makes the necessary economic and social adjustments."

Blinder believes rich countries must "reorganize the nature of work to exploit their big advantage in nontradable services." This will mean reconsidering the way the U.S. work force is trained. On balance, he argues that a greater focus on education is probably welcome, especially if a more educated labor work force is also more flexible and can cope more readily with occupational change. But since the distinction between personal services and impersonal services does not necessarily correspond to skill level, "providing more education cannot be the whole answer."

But there's a catch: Blinder is also a believer in "Baumol's disease," which implies that achieving productivity improvements in many personal services is difficult to impossible. That's bad news for a nation pegging its future to personal services. It means prices of personal services will rise relative to other prices. "When you add to that the likelihood that the demand for many of the increasingly costly personal services is destined to shrink relative to the demand for ever-cheaper impersonal services and manufactured goods, rich countries are likely to have some major readjustments to make," Blinder says.

But the United States need not despair, he says. The more fluid domestic labor market is likely to adjust faster to the demands of the third Industrial Revolution than European markets. And personal service jobs bring less alienation and greater job satisfaction than impersonal ones. That said, big changes are afoot, Blinder concludes: "Offshoring will likely prove to be much more than just business as usual." **RF**

Fed to Begin Paying Interest on Reserves

BY JOHN WALTER AND PATRICIA WESCOTT

On Oct. 13, 2006, legislation was enacted granting the Federal Reserve System a new power: to pay interest on balances held by depository institutions at Federal Reserve banks, even balances in excess of reserve requirements. Holding reserves at the Fed is mandatory for insured U.S. depository institutions, which include banks, credit unions, and savings institutions. The amount that institutions must set aside (either as balances at the Fed or as vault cash) varies but in most cases is about 10 percent of total deposits.

Reserve requirements can help foster the implementation of monetary policy because they create a predictable demand for reserves. Paying interest on reserves is not a new idea. In fact, the Federal Reserve has long promoted it, and the Nobel Prize-winning economist Milton Friedman advocated the idea more than 40 years ago. The provisions will take effect on Oct. 1, 2011.

Proponents argue that the legislation could lead to a number of improvements. First, depository institutions today expend considerable resources to minimize their required and excess reserve balances. They do so because the Fed does not pay interest on such balances. Thus, every dollar held on deposit at the Fed as reserves is one less dollar that can be employed elsewhere to earn interest. There will be fiscal costs to paying interests on reserves. However, since the Fed will earn interest on any new, excess reserves, it can at least partially offset these costs.

Depository institutions spend significant time and money to shift funds away from liabilities on which the Fed imposes reserve requirements and into liabilities on which it does not. Sophisticated, and costly to establish, bank sweep programs move customer funds from deposits that are subject to reserve requirements.

In addition, banks incur personnel and software costs to closely monitor reserve holdings, trying to ensure that *only* the required minimum is held. Such monitoring is complicated and costly because reserve balances serve a dual role: 1) meeting reserve requirements and 2) providing the channel for interbank payments. Banks want to hold no more than necessary to satisfy these two needs because they earn no interest on reserves.

Once the Fed pays interest on reserves, depository institutions will have less need to expend resources minimizing their balances. The upshot may be that a more efficient economy is produced. Depository institutions can spend fewer resources to keep tabs on reserve requirements and redirect their efforts to more useful projects.

When the Fed begins paying interest on required reserves, and especially if it decides to pay interest on excess reserves, the payoff from investments in personnel to monitor reserve balances will diminish. Currently, with no interest payments on required and excess reserves, the payoff is equal to the difference between market interest rates and zero, so the payoff is the market rate. Once the Fed pays interest, the payoff will be the difference between the market rate and the rate the Fed pays, which is likely to be fairly small, on a risk-adjusted basis. With a smaller payoff, depository institutions will decrease their spending on monitoring their excess reserves.

Once the Fed pays interest on reserves, depository institutions will have less need to expend resources minimizing their balances.

Payments system risk could be moderated by the payment of interest on reserves, especially if interest is paid on excess reserves and such reserves increase. The Federal Reserve and depository institutions face the risk that a depository will have insufficient funds on hand to make a required payment. In such a case the defaulting institution's troubles could lead to financial difficulties for other institutions. With little or no excess reserves, institutions at times rely on expected funds from other institutions in order to complete their own payments; so the default of one institution can create problems for others. Paying interest on excess reserves would encourage depository institutions to hold excess reserves. Any additional reserves reduce the chance of defaults since depositories will have a larger buffer against payments demands.

The Fed's job of implementing monetary policy could be eased somewhat by paying interest on reserves. The Fed conducts monetary policy through its ability to influence short-term interest rates. More specifically, it attempts to maintain the federal funds rate — the interest rate depository institutions charge when lending reserves to one another — at a varying target rate that is determined by the Federal Reserve to keep inflation in check while allowing for sustainable economic growth. Observers argue that the fed funds rate is likely to be less volatile if the Fed pays interest on reserves. As a result, the Federal Reserve will have an easier time hitting its target. Of course, as with any new policy, the magnitude of these anticipated benefits is uncertain. **RF**

John Walter is a research economist and **Patricia Wescott** is a research analyst with the Federal Reserve Bank of Richmond.

Banks of All Sizes

BY DOUG CAMPBELL

"Changes in the Size Distribution of U.S. Banks: 1960 - 2005." Hubert P. Janicki and Edward Simpson Prescott, Federal Reserve Bank of Richmond *Economic Quarterly*, Fall 2006, vol. 92, no. 4, pp. 291-316.

It's no secret that the U.S. banking industry has experienced significant consolidation over the past few decades. Amid rapid consolidation, the number of banks operating in the country since 1960 has fallen from 13,000 to about 6,500. The conventional wisdom is that there is no end in sight to this trend, with the big banks getting bigger and midsized banks all but disappearing, to create a "barbell" industry shape. In a new article, researchers at the Federal Reserve Bank of Richmond call into question elements of the conventional wisdom. Hubert Janicki and Edward S. Prescott document the decline in bank numbers and draw several new findings. Among them: The pace of new bank openings has been relatively constant over time. Entry averages about 1.5 percent of total operating banks.

The authors also document striking changes in bank growth starting in 1980, about the time when deregulation started. They find that before this point, bank growth was consistent with "Gibrat's Law," which states that firm growth is independent of firm size. After 1980, they find that Gibrat's Law no longer holds; instead, the largest banks grow the fastest, though that has slowed down recently.

The authors forecast that the number of U.S. banks is likely to continue dropping, but soon may level off. This prediction is based primarily on observations from the (admittedly brief) period from 2000 to 2005. "If the present trends continue, the transition in banking that began in the 1980s is slowing down and coming to an end," the authors write. And despite the prediction of a "barbell" banking industry structure — with many big and small banks, but very few midsized ones — the projected remaining 5,000 banks probably won't have such a shape. Instead, Prescott and Janicki see "more midsized banks than large banks" – much as it is now shaped.

All of this helps lay the factual foundation for a theory of how many banks there will be in the future, and how many of those will be big, medium, or small in size. Such a theory can establish the costs and benefits of past limits on bank size and evaluate policies that affect bank size distribution.

"A theory of the changes in bank size distribution needs an explanation of why the size dynamics changed and by how much," the authors conclude. "The natural place to start is with an understanding of how removals to growth and size limits change the growth rates of different size banks."

"How Resilient Is the Modern Economy to Energy Price Shocks?" Rajeev Dhawan and Karsten Jeske, Federal Reserve Bank of Atlanta *Economic Review*, Third Quarter 2006, vol. 91, no. 3, pp. 21-32.

One of the longer-running debates in modern economics centers on whether business cycle fluctuations are more likely to be triggered by energy price shocks or productivity shocks. On one side, Dhawan and Jeske argue, are the empiricists who claim that energy price shocks are the primary cause, while on the other are economists whose "dynamic stochastic general equilibrium" models suggest that we should look at shocks to total factor productivity (TFP) instead.

In a new paper, the authors reconcile the two arguments by building a model that takes into account energy use in the production function. They find that big changes in energy prices *can* have business cycle effects if they also affect the underlying productivity trend. That appears to have been the case from 1970 to 1985. But since then, it is harder to identify how productivity has been affected by energy price shocks.

But the economy is not recession-proof. "While the economy is more resilient to energy price shocks than before 1985, it is still subject to fluctuations in TFP unrelated to energy price hikes."

"The Relocation Decisions of Working Couples." Jonathan F. Pingle, Federal Reserve Board of Governors Finance and Economics Discussion Series Working Paper 2006-33, August 2006.

The United States has about 33 million households with both spouses working outside of the home. This poses a problem. If one spouse gets a job offer in another city, acceptance tends to be contingent on whether the other spouse can likewise find gainful employment. Increasingly, couples move only when one spouse gets a big enough raise to more than offset the other spouse's lost earnings.

Jonathan Pingle, an economist with the Federal Reserve Board of Governors, finds that early-career location decisions are especially important. "[C]ities attracting young, high income couples will likely keep them — cities like Washington, San Francisco, or Seattle," Pingle writes. "As migration continues to decline, this could sort the most productive labor away from cities that cannot find ways of attracting the young and the educated before they marry, form dual-worker households, or have children — after which relocation becomes difficult even if one of the spouses gets a good job offer elsewhere." **RF**

UPDATE ON FINANCIAL TURNAROUND

Albemarle First Boosts New Owner

The fall 2006 issue of *Region Focus* went to press just before an announcement that was pertinent to the article, "The Life and Times of Albemarle First." In October, Winchester, Va.-based Premier Community Bankshares reported third-quarter earnings of $2 million. What was notable about those results was the contribution made by Albemarle First, which Premier had acquired July 1.

As readers of the article may recall, Charlottesville-based Albemarle First had struggled in its early years to overcome lending problems and a check-kiting scheme. But more recently a financial turnaround seemed to be taking hold, amid a concerted effort by new management and staff. (A new executive team was put in place in early 2002, starting with the appointment of CEO Tom Boyd.) Premier's third-quarter announcement appears to support the conclusion that the turnaround was complete: Albemarle First provided profits of $455,000, the highest quarterly total in the acquired bank's history.

On Jan. 29, Premier announced it was being acquired by Charleston, W.Va.-based United Bankshares, pending regulatory and shareholder approvals. — Doug Campbell

BEST PRACTICES

West Virginia Encourages IT Investment in Health Care Industry

Technological advances have revolutionized the diagnosis and treatment of illness. Yet the revolution in information technology, ranging from electronic record-keeping to wireless communications, hasn't had as big an impact on the health care industry. Doctors still lug around thick folders stuffed with records and x-rays, making it difficult for different practices to share information on the same patient. Verbal and written orders from doctors can be misinterpreted, leading to deadly medical errors in hospitals.

West Virginia is among states trying to change the status quo. Since March 2006, it has facilitated the development of a statewide health information network, which was recommended by a task force created by Gov. Joe Manchin in 2005 and touted in the governor's last three State of the State addresses.

David Campbell, chief executive officer of the nonprofit Community Health Network of West Virginia, believes this network would support the use of electronic medical records (EMR) and the free flow of information between doctors, hospitals, and insurance companies. "The government won't build and operate the system, but it does have a public interest in encouraging its development," Campbell says. Banking and other industries have used information technology to make their operations more efficient and improve the quality of services. "We haven't done that in health care."

Information technology may improve the quality of patient care. Devon Herrick, a senior fellow at the National Center for Policy Analysis, says software could check for contra-indications when a doctor writes a prescription. More important, "massive data mining of EMR systems will, in the long term, help establish best practices and evidence-based treatments," Herrick adds. "By adopting best practices and coordinating care, quality will hopefully be better."

Such quality improvements could yield cost savings for providers. Better patient safety would reduce the costs incurred to correct medical mistakes. Fewer duplicative tests would be ordered because medical records would be more accessible.

Health care insurers could save money as well, adds Sallie Hunt, an official at the West Virginia Health Care Authority involved in the creation of the state's health information network. For example, electronic prescribing of medications would enable insurers to better manage their costs through the use of formularies, preferred lists of drug products that have been deemed to be the most cost-effective. A doctor could use a wireless handheld device to select drug options presented for patients based on their insurance coverage.

So why aren't health care professionals lining up to buy wireless routers? Some blame the fee-for-service system of health care reimbursement. Third parties pay the same price for medical services regardless of how efficiently they are provided.

"Doctors are not being paid for high-quality care coordination. Rather, they are being paid by the task," Herrick notes. "When more people begin paying for medical bills directly, such as from a [health savings account], they will begin to demand timely access to their medical information and will want efficient care."

However, even under the current fee-for-service regime, a doctor could cut costs and boost profits by implementing IT. The problem is it takes time for providers to learn about new technologies and implement them in order to achieve the maximum cost savings. Doctors are always working under a time crunch, so the opportunity cost of the transition may not outweigh the savings, which are in the long run and may not seem as significant or certain. There are also privacy concerns. Once patient records are put into electronic form, arguably they become more vulnerable to being accessed by unauthorized persons.

Finally, it's not cheap to implement information technology. In a survey of physician groups and individual practices, Robert Miller and Ida Sim at the University of California at San Francisco found that the upfront costs for deploying an EMR system ranges from $16,000 to $36,000 per physician.

These expenses include equipment purchases and installation, conversion of existing paper-based information into digital form, and training personnel. They don't include the revenue that is lost during the transition period due to productivity declines.

Hospitals and large physician groups are better able to absorb these costs than smaller groups and individual practices, plus they have the management expertise and organizational scale to make other changes necessary to realizing the full benefits of information technology. For example, the Carolinas HealthCare System began installing wireless access points throughout its 14 hospitals in North Carolina and South Carolina in 2004. This investment will enable doctors to instantly access patient orders, lab results, and other information.

Should states or Uncle Sam help foot the bill for IT investment in the health care industry? A 2002 Institute of Medicine report called for government funding of large-scale demonstration projects to test the implementation of health information networks. But, Miller and Sim believe that governments don't need to directly fund networks or subsidize IT purchases by health care professionals.

"Our study suggests that most practices can secure capital for purchasing the technology," the researchers note in their March/April 2004 article in *Health Affairs*. "Policy funds could be better used for rewarding quality improvement, for example, than for replacing available sources of capital." — Charles Gerena

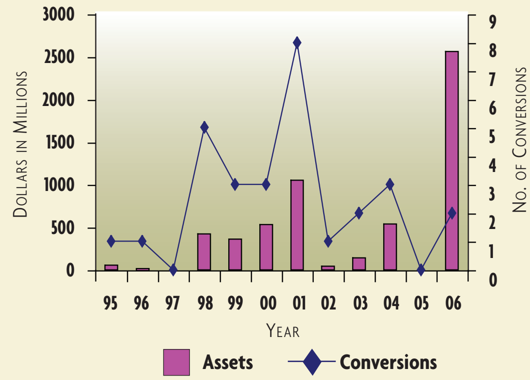
THE CONVERSION QUESTION

Credit Unions Weigh Costs and Benefits of Converting to Banks

Since 1995, the first year they were allowed to do so, 29 member-owned credit unions have turned into either mutual holding companies or stockholder-owned banks, either through direct conversion or through mergers. In the Fifth District, four credit unions have made the switch. It's usually a two-step process beginning with a membership-wide vote first on whether to convert to a depositor-owned, mutual savings bank, then concluding with another vote on conversion to a stockholder-owned bank. Also required are approvals from regulators.

Generally, conversions are instigated by management and pitched as the best means for the institutions to survive. Lafayette Federal Credit Union of Kensington, Md., was one of the most recent credit unions to undertake the process for conversion. The effort has recently stalled amid concerns about the voting process for conversion of the 16,000-member institution. But before Lafayette Federal withdrew its conversion plan, CEO Michael Hearne explained why he favored the effort. "The name of the game is grow or die. It's increasingly expensive to do business and the only way you pay for additional expenses is to bring in additional revenue, and the only way you do that is to increase volume," he said. "It's much easier to grow as a thrift than a credit union."

Credit Union Conversions, 1995-2006



SOURCE: Filene Research Institute

The first U.S. credit union opened in 1909 in New Hampshire. In the early days, credit unions were founded to serve members of a specific organization with small consumer loans. They developed under the premise that their members' common interests and bonds could serve as a substitute for collateral, explains Richmond Fed economist John Walter. In 1932, the average size of a U.S. credit union was just 187 members. "With this knowledge in hand, the credit union loan committee could make a low-risk and, therefore, low-interest loan to a credit union member," Walter writes in a recent article.

This distinguishing characteristic no longer exists so strongly. Today's credit unions can span numerous employers and geographic areas, diminishing old "common bond" insights into lending. At the same time, however, they have gained mortgage lending powers and expanded their business lending.

Most important, as nonprofits, credit unions still maintain their exemption from federal income taxes unlike banks. That tax-exempt status bothers community bankers, who complain that credit unions present unfair competition because they can use their tax-bill savings to undercut bank prices.

So why would credit unions, with their built-in tax advantage, want to convert? One reason may be that some of their original competitive advantages have eroded. Creditworthiness is more easily identified by all financial services players nowadays thanks to innovations in the financial marketplace. Also, even as credit unions have grown to close to 90 million members, they remain smaller in comparison to commercial banks. About half of all U.S. credit unions have less than $10 million in assets, while only 1 percent of all banks are that small, Walter writes. Many credit unions are looking for growth opportunities, but as they are currently organized, those opportunities are limited.

James Wilcox, an economist at the University of California at Berkeley, has studied credit union conversions. Credit unions have to use retained earnings as their only source for meeting capital requirements, unlike banks which can raise capital in many different ways. Wilcox says that credit unions that offer superior rates and services probably shouldn't be converting; they can better serve members as credit unions. But he adds that credit unions which offer similar rates and services to banks make for good conversion candidates. "What members ought to figure out is that they own this thing and then whether it's better to cash out now or keep the cash coming," Wilcox says.

However, conversions can be controversial. Usually the controversy stems from how the equity is divided up after conversion. Typically, credit union members are offered the opportunity to buy shares of the new bank before those shares are sold to the public. By law, shares can't be distributed to members in exchange for their claims to retained earnings. Meanwhile, fewer than one out of 10 members end up purchasing shares of the converted institution.

That number would increase, Wilcox thinks, if the rules were changed for how credit union equity is disbursed. He proposes that both credit union depositors and borrowers be compensated for their "lifetime contributions" to the institution. At the very least, it would be a fairer system than the present. "Life is messy, and half a loaf or two-thirds a loaf is better than none," Wilcox says.

In late December, Lafayette Federal's board and management thought it had overcome equity concerns in winning a membershipwide election to convert to a mutual savings bank. But given the balloting problems, the Lafayette Federal board said it would terminate the conversion plan and anticipated "no immediate changes in our operations."

Hearne, Lafayette's CEO, says the board tried to allay equity issues by pledging, in the event of such a conversion, to not accept stock grants, options, or any payments and buy stock under same considerations as other members. "I don't know what else could have been done to say that this shouldn't be an issue," Hearne says. "But that's the most visceral issue here. I understand why." — Doug Campbell

RAISE THE ROOF

Tunnel Clearance Could Open Access to Southern West Virginia

Twenty-eight rail tunnels, four in Virginia and 24 in West Virginia, are getting taller. Starting this summer, the tunnels will be modified to accommodate double-stacked railcars that move goods inland, mainly to Chicago and other Midwest cities, from Hampton Roads port terminals. The project aims to lower costs while speeding the transport of goods.

The price tag for tunnel clearances alone is estimated at $151 million. At least one tunnel, Big Four # 2 near Welch, W.Va., will be "daylighted," meaning its top will be blasted off. It's a big project, with Norfolk Southern Corporation getting taxpayer help to realize economic benefits sooner rather than later. The improvement wasn't at the top of the railroad's to-do list, from a shareholder perspective, says Mark Burton,

Raising tunnels to accommodate double-stacked containers on trains will move cargo more cheaply and efficiently from Hampton Roads ports to Chicago.

director of transportation economics at the University of Tennessee's Center for Transportation Research.

Burton says railroads are under pressure to increase earnings. "That has really squeezed the level of investment to something below what the railroads would have liked to have seen." Any savings for Norfolk Southern probably will go to keep rates competitive, thus benefiting shippers who could always land at another deep water port and load onto rival rails, Burton notes. CSX, for example, already double stacks on routes from its Charleston, S.C., terminal. "This puts them on equal footing with CSX," he says.

Federal funding is estimated at $95 million and Virginia will pay $22.5 million toward the clearance and construction of an intermodal terminal in the Roanoke region. West Virginia is likely to fund most of a terminal proposed for Prichard, W.Va., near the Ohio River.

Construction will begin this summer on the tunnel clearance portion of the project, slated for completion in 2009. The entire effort, which includes a terminal and construction work in Ohio, too, is called the Heartland Corridor.

Double-stacked containers from ships load directly onto railcars at Norfolk, the most efficient way to move containers between Norfolk and Chicago, says Robin Chapman, Norfolk Southern spokesman. Stacked trains currently travel the long way around to Chicago, avoiding West Virginia, Southwest Virginia, and low tunnels altogether. The more direct route clips 233 miles and a day's travel time off the trip to Chicago. The shortcut runs through Roanoke, Va., and Southern West Virginia by way of Columbus, Ohio, a distance of 1,031 miles compared to 1,264 miles.

Double stacking cuts costs nearly in half, Burton says. "Single-stack shipments are sometimes competitive with trucking prices and sometimes not," he says. "Double stacks always generate profit."

West Virginia could win big economically from the increased container traffic, especially if plans for an intermodal terminal in Prichard, W.Va., materialize. Intermodal terminals where trucks, trains, and even barges come together serve as inland ports, giving manufacturers easy, direct access to coastal ports for overseas markets. "What the intermodal terminals do is bring to the regions where they're located the capability for companies in that region to connect more directly to the international markets," Chapman says.

PHOTOGRAPHY: NORFOLK SOUTHERN CORPORATION

Direct access means business, says Patrick Donovan, executive director of the West Virginia Public Port Authority. "What that does is give Southern West Virginia, Kentucky, and Ohio global reach other than the river system. When you look at our proximity to Midwest markets out of West Virginia, it's pretty impressive."

For the state to retain and recruit firms, the intermodal terminal is critical. Container traffic over the deep draft ports — such as Norfolk and New York — has grown by double-digit percentages in all but one of the last 10 years, Burton notes. "The huge growth and importance of container traffic is directly tied to international traffic," he says. "The reason global markets work, the reason we're wearing so many Chinese tennis shoes, is that international shipping by container has become remarkably cheap."

Currently, any manufacturer in West Virginia faces a $400 to $600 disadvantage per container. "So firms that want to use containers don't locate there," Burton says. Norfolk Southern provided the state with $1 million for preliminary engineering of the Prichard site.

Consumers may benefit as well. Take beer, a product that ranks high on the inbound commodities list, says Burton. "Somebody who likes to drink German beer would be able to buy it more affordably." — Betty Joyce Nash

WEST VIRGINIA'S MEDICAID MODIFICATION

New Program to Encourage Personal Responsibility for Health Care Decisions

West Virginia is testing a first-of-its-kind program: providing incentives for the state's poorest people to accept more personal responsibility for their health. The pilot program has begun with three counties — Clay, Upshur, and Lincoln — asking patients to sign "member agreements" that give access to services not usually covered by Medicaid. Members with diabetes or weight problems, for example, could attend nutritional seminars or meetings with dieticians. On the flip side, beneficiaries who don't sign the agreements face limits on the number of prescriptions they receive and don't get access to extra benefits.

As with most states, West Virginia's funding of Medicaid — the nationwide health care program that covers medical services for the poor — constantly strains the budget. But the pilot program is not being pursued as a short-term cost fix; it is a long-term effort to improve the health and well-being of West Virginia's poorest residents, officials say. By extension, over time it is hoped the program contains costs. (Other states are modifying Medicaid coverage, too. Kentucky, for example, is restricting the number of prescriptions some beneficiaries can receive. But West Virginia's program is the first to provide incentives toward improving health.)

The idea was approved by the federal government in the summer and started in late 2006. Initially, the target population is the young and healthy poor, a demographic that at present isn't a drag on Medicaid expenditures but which could be if future lifestyle choices make them unhealthy.

"We want these people to make healthier decisions and we want to partner with them to make these healthier decisions," says Shannon Riley, spokeswoman for the West Virginia Bureau for Medical Services. "If we can eliminate lifestyle-induced diseases in this young and healthy population, that significantly slows the growth of our [Medicaid] program in the future."

While private insurers and even public health departments have been trying for some time to build incentives for patients to take more interest in their health, Medicaid has never been the ground for such efforts. The federal government pays for about 57 percent of the $275 billion nationwide program, with states covering the rest.

Robert Helms, a resident scholar on health care policy with the American Enterprise Institute, says the West Virginia program is a good first step. The program is in keeping with recommendations of the Medicaid Commission's 2006 report, to which Helms contributed, to give states more control and flexibility in administering Medicaid.

In a roundabout way, West Virginia's "Mountain Health Choices" program helps ease the classic health care problem of those receiving a service not directly paying for it, which creates all the wrong incentives. Recipients agree to keep doctor appointments, only use the emergency room in case of real emergencies, and comply with prescription medications, among other responsibilities.

"I'm very supportive of what they're trying to do, with the principle of trying to help more people be more responsible," Helms says. "It's moving in the right direction. And the cost benefits may even be secondary to improving the quality of these people's health, preventing them from becoming serious Medicaid patients in the first place."

While patients who sign up for the program are eligible for enhanced services, those who don't are relegated to another plan. The "Basic Plan" limits prescriptions to four per month, for example, while the "Enhanced Plan" has no limit. This difference has given rise to some criticism. A short article in the Aug. 24 edition of the *New England Journal of Medicine* questioned whether some Medicaid patients, especially children beholden to their parents' actions, would be denied necessary medical services under the plan.

But Riley, the West Virginia spokeswoman, says the program is not about withholding care as much as it is about rewarding patients who take steps to improve their health. All Medicaid beneficiaries have the opportunity to sign up for the enhanced plan each year. "Honestly, it's kind of insulting to insinuate that poor people can't make good decisions," Riley says.

In the next year, the state aims to add new features to the program, offering more programs not typically covered under Medicaid, though details still have to be worked out and approved by the federal regulator, the Centers for Medicare and Medicaid Services. The idea is to expand the program statewide, eventually covering a majority of the state's 380,000 Medicaid beneficiaries. — Doug Campbell

OPTIONS ON THE OUTS

The popularity of employee stock options is expected to wane with the adoption of a new accounting rule

BY DOUG CAMPBELL

April 27, 2004, was a good day at RF Micro Devices Inc. On that date, the Greensboro, N.C., company reported its first full year in the black since 2001. "We turned the corner on profitability," CEO Bob Bruggeworth said in the day's press release.

RF Micro Devices was founded in 1991 by a small band of local engineers and then built into a multinational firm with offices in Silicon Valley and China. The cellular phone components market in which it competes is a growing but tough business. Turning the corner on profitability was welcome news indeed.

But there was no big move in RF Micro's stock price following the positive earnings report. As is the case with most financial announcements, it would have taken a big surprise for the stock price to have been affected. In fact, the market was already taking into account something that RF Micro wasn't announcing that day — looked at another way, the reported $30 million profit was actually a loss of $25 million.

This news wouldn't officially come until two months later in RF Micro's annual report, filed with the Securities and Exchange Commission. The reason for the difference between the announced net income of $30 million and the "pro forma" loss could be found on page 28 of form 10-K in a footnote headed "Stock-Based Compensation." It showed that in RF Micro's latest fiscal year, the value of stock options (and to a lesser extent, certain outright stock awards) granted to employees was costing the firm about $62 million. Deducting that amount from earnings (plus adding in credit for a few other items) pushed the firm into the red.

It wasn't the first time RF Micro had reported a profit when in an alternate — some would say "economic" — reality, it had lost money. The same thing happened in 2001. And in every other year of its existence, the firm's profits were actually lower than reported because of stock option grants, and its losses likewise larger.

This is not to say that RF Micro was engaged in fraudulent behavior, or even doing anything unusual for that matter. Until this year, practically

PHOTOGRAPHY: GETTY IMAGES

every publicly traded firm in the country reported the cost of expensing employee stock options in footnotes. Scores would have reported losses instead of profits if employee options had been expensed. (In 1999, for instance, the number of U.S. technology firms reporting losses would have doubled if options had been deducted from profits.) RF Micro Devices just happens to be a good example of how this process worked — and perhaps of how managers tend to make decisions based on accounting numbers instead of economic ones.

To many, stock options in the 21st century have become synonymous with corporate greed. But that's hyperbole which ignores some of the positive things that options can do — like align shareholder and employee interests by motivating workers to boost their company's performance and drive stock prices upward, for starters. Stock options help companies like RF Micro grow faster than they otherwise could have.

At the same time, many managers and boards until recently were seemingly blind to the true costs of stock options, an anomaly that economists are striving to explain. And this unawareness had a number of negative implications for investors. Misjudging options as much cheaper than cash, managers were more likely to lavish them on employees. Meanwhile, option grants to top executives grew so widespread that the average CEO today makes about 262 times the average employee. Perhaps the executives are worth every dollar, or perhaps this is what happens when a big chunk of compensation gets accounted for as virtually free. Finally, the recent scandal over the practice of "backdating" employee stock options may have some of its roots in the relatively painless way firms were allowed to account for options.

Today, granting options is no longer painless: 2006 is the first year that public companies are being required to subtract the cost of stock options from their income. The change, which was years in the making, came about in large part because of clamoring for corporate governance reforms. Accounting scandals at Enron and WorldCom gave the Financial Accounting Standards Board (FASB) support for a long-proposed rule to make stock option expensing mandatory, instead of something that since 1995 was relegated to footnotes in annual company filings. (And before 1995, usually not reported at all.)

Across the nation, this one small accounting change is affecting the use of employee stock options in a significant way.

> The price that the firm would fetch in the market for this asset would be its economic value. Anything less, and shareholders arguably are being ill-served.

Stock Option Basics

Employee stock options represent the right to buy a share of stock at a specified price — called the exercise or strike price — before a specified date. Unlike standard, short-lived "call options," employee options usually cannot be sold to outside investors (see sidebar, Google). Also, they tend to have lengthier terms, sometimes of up to 10 years, and usually include vesting periods.

Here is how it works. A firm issues an option to an employee. The option usually has an exercise price identical to the price of the firm's stock on the day the option is issued. So if the stock is trading at $10 on that day, the exercise price is also set at $10. If the option vests in four years, then the employee will have the right to buy a share of stock four years later at $10, no matter what the firm's stock price is at that future time. If the firm's stock price has doubled to $20, an employee can buy that $20 share for just $10, then immediately turn around and sell it at the market price, pocketing the $10 difference as profit.

The vesting period is the key to an option's utility in retaining and motivating employees. The idea is that workers will perform at a higher level so as to raise the stock price, knowing that a higher price is in their direct interest. At the same time, other shareholders benefit — a seeming resolution to the age-old agency problem, aligning incentives of both the owners and the agents. (As an added bonus, the tax treatment for stock options is less expensive compared with cash payments and stock grants.)

Employee stock options were still something of a rarity in 1972 when a new rule was established to require that companies treat options as an expense as measured by their "intrinsic value" — which is the difference between the stock price when issued and the exercise price. Thus, the intrinsic value sets a lower bound on the exercise price, and hence its valuation. If the exercise price is set at the trading price of a stock on the day it is issued, then no expense is recorded. For example, a company whose stock was trading at $10 would issue options with strike prices of $10 on that day so as to avoid the expense. Because of this, virtually all employee options issued after 1972 were "at the money," or with identical exercise and trading prices on the day they were issued. Another way to view it is that firms were essentially allowed to ignore the cost of employee stock options.

In 1995, as option grants grew more popular, the FASB issued a new rule that firms must also, at the very least, report the "fair value" of employee options in footnotes to their regulatory filings. (The FASB had wanted this information to appear in the main income statement, but firms lobbied to prevent this from happening.) Fair value is calculated by using formulas that involve estimating the number of granted options which will vest and the expected volatility of the firm's stock price until the exercise date, among other factors that are impossible to nail down with precision.

"Fair value" aims to derive the underlying economic value of granting options. Unlike an accounting valuation, an economic valuation seeks to reflect the "opportunity cost" of a firm's decision about how to deploy its assets. In the case of a stock option, the relevant question is: What else could be done with it? A firm could sell it to an outside investor, for example. The price that the firm would fetch in the market for this asset would be its economic value. Anything less, and shareholders arguably are being ill-served.

Consider the easiest way that firms could account for stock options — they could buy them from third parties and then give them to employees. True, this would trigger an upfront, one-time expense. As Robert Bliss, a former senior economist with the Chicago Fed now at Wake Forest University put it: "That this form of employee stock option is not widely adopted reveals something of the motive behind their current usage — to transfer value to the employee without the appearance of an actual expenditure."

Wayne Guay, an accounting professor at the University of Pennsylvania, acknowledges that valuing employee options is tricky. But that's the nature of accounting, he says. Placing a dollar value on things like "goodwill" and pension plans likewise is fraught with assumptions and possible imprecise-ness. Moreover, just about every single number in a financial statement is an estimate, from cash on hand to inventory. "Of the list of things that are currently reflected in the income statement, valuing employee stock options does not strike me as one of

Google to Introduce Transferable Options

Internet search and information firm Google recently introduced a novel kind of stock option, one that employees can sell to outside investors. Historically, most employee stock options have been nontransferable, though firms like Microsoft have in the past offered one-time programs for employees to sell options.

Google's plan is thought of as the first to be rolled out on an ongoing basis, with a regular market in which financial institutions and other investors can offer to buy employee options. The company pitched the idea as a way to increase the value of employee stock options — or at least the value that employees place on them. The higher perceived value of "sellable" employee options results from the fact that employees nowadays tend to exercise their options almost immediately after they vest. (Google had its initial public offering in 2004, and since then many of its employee options have vested and been exercised.) But profits from options in many cases would have been greater if the employee had waited for the firm's stock price to rise. By selling vested options to optimization-minded investors and financial institutions instead of exercising immediately, employees are likely to pocket bigger profits.

The program "makes the value of [employee] options more tangible," said Allan Brown, director of Recognition and HR Systems on Google's blog. "By showing employees what financial institutions are willing to pay for their options, it is made clear that the value of their options is greater than just the intrinsic value." (By intrinsic value, Brown meant the difference between the exercise price and the current market price.)

Google's plan is an example of how many firms continue to believe in the power of stock options, even as expensing them has made more apparent the economic cost of issuing them. In fact, Google predicts that its cost of issuing options will rise with the plan because it will increase the expected life of the options. The plan will convert all post-IPO options to transferable ones, along with all newly issued options. It is to go into effect in the spring of 2007 and will not be available to senior executives. Google says it awards options to all new employees and then annually to many others.

Google's timing in introducing transferable options has ties to the new requirement of stock option expensing. Google said that one of its aims was to close the gap between the amount of stock option expense that the company has to subtract from earnings and the amount which employees perceive their options are worth. The amount that has to be deducted from earnings is based on options-pricing formulas, with Google using the standard Black-Scholes-Merton (BSM) pricing model.

In a statement about accounting for transferable options, Google explained: "Because traditional employee stock options are not transferable, there is a disconnect between their value as determined using BSM — which, under the new accounting rules, we recognize as stock-based compensation as the options vest — and the value employees ascribe to their options on the date of grant. The [transferable stock option] program diminishes this disconnect."

Carl Luft, a finance professor at DePaul University who has studied stock options, says that Google's effort means it's possible that market-determined prices for employee options will someday be the way that firms value such options in their financial statements. This would help end the debate over the best way to value options and complaints that current formulas are imprecise, even though the prices are likely to come out pretty close to each other. "My guess is that the market price will converge with one of the theoretical pricing models pretty quick," Luft says. "And that will provide a hard number that can be used in reporting rather than the number that is subject to criticism."

— Doug Campbell

LOGO: COURTESY OF GOOGLE

the most difficult things that we currently estimate," Guay says.

Still, managers complain more about valuing options than other items. They note that although it usually takes at least several years for employees to see any economic gain — and gains may never materialize at all — firms have to begin expensing the options immediately. Likewise, they argue that valuations are at best estimates. What's more, the formulas used for valuing employee options were originally developed for standard-issue options. The difference is important because employees tend to exercise options immediately after they're vested, even if they are not optimally priced at that time, which is contrary to what the standard formulas say they should do.

In addition, some firms dispute the very necessity of expensing options. They point out that granting options doesn't affect cash flows, the fundamental measure by which shares are valued. Also, small and young firms in particular claim that expensing options will make their reported earnings lower, which in turn would raise their cost of financing, perhaps then choking off future investment and innovation.

In a 2004 paper, economists R. Glenn Hubbard and Charles Calomiris of Columbia University argued that "the noise produced in accounting earnings by the decisions by the [Financial Accounting Standards Board] about 'true earnings' are ill-advised." Better, Hubbard and Calomiris said, would be to leave the valuation of options to Wall Street professionals, whose sophisticated, informed analyses play a central role in setting stock prices at the margin.

Yes, Hubbard and Calomiris agree, options represent a bona fide expense that needs to be disclosed. But the myriad different ways that they can be valued mean that investors may end up not comparing apples to apples when looking at numbers across different companies. "The primary role for regulation should be in the area of disclosure, which will ensure that competing approaches to measuring option costs are based on the same basic information," Hubbard and Calomiris wrote.

Moreover, the evidence suggests that the footnoted valuations are actually quite effective and informative. A number of studies have concluded that the market properly takes notice of these footnotes and assigns market values accordingly. Summing up the economic argument against an official expensing of options, Cleveland Fed economist Joseph Haubrich said: "Why should it matter if this information is reported on one line rather than another? Put differently, if the market already values these options, there would be little benefit to counting them as an expense."

Pushback

Haubrich actually is more agnostic about how to deal with stock options than his quote implies. He notes that former Federal Reserve Chairman Alan Greenspan was a moderate proponent of expensing options, in part because he was doubtful that markets actually do fully see their true costs. What's more, even if the market cannot be fooled by stock options, there is ample evidence that boards and managers can.

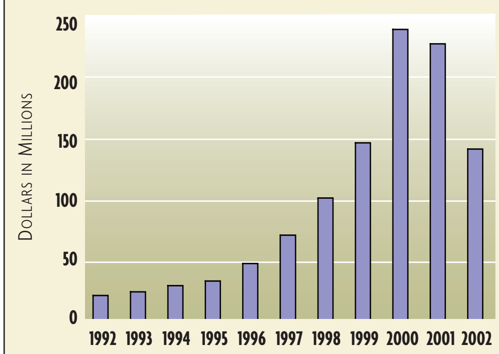
Consider the voluminous comments the standards board received from corporations in advance of adopting the expensing rule. "We continue to believe that, because no corporate assets have been consumed nor liabilities created, the issuance of a stock option conceptually does not result in an expense to the corporation," said Rajeev Bhalla, former controller for Bethesda, Md.-based Lockheed Martin. Or reflect on the words of Billie Rawot of Cleveland-based Eaton Corp.: "Employee stock options do not represent an expense to the company that should be recorded in the income statement."

Though not all firms denied the very existence of a "cost" in issuing employee stock options, many argued in letters to the standards board that the new rule greatly overstated their expense. This complaint was at the heart of doomsday scenarios raised by the likes of Christine Copple of Washington, D.C.-based ASM Resources: "The most talented scientists and researchers are much more likely to depart the United States for other nations. We must maintain our competitive edge in attracting the world's top scientists." In other words, Copple was saying that ASM would have to pare back on its option grants if it had to expense them — even though it was already doing so in the footnotes.

As a result of these kinds of perceptions, U.S. firms were nearly unanimous in their support of maintaining the status quo of keeping option expenses in footnotes. But did this make sense? How could firms simultaneously argue that a) footnotes provide adequate information about stock option expenses and b) incorporating this same information into their main income statements would be harmful? As economist Haubrich notes, "Only if, for some reason, the government both wants to subsidize ... firms and finds that the cheapest way to do so is to ignore the option expense, does this story make sense."

Perhaps something else is going on. To understand what, RF Micro Devices serves as a useful illustration.

Grant-Date Values of Employee Stock Options in the S&P 500



SOURCE: Hall and Murphy, 2003

Grants Galore

From almost the moment it was founded, RF Micro Devices relied on stock options as a major part of its compensation program. Like at a lot of young, high-tech firms, RF Micro's leadership reasoned that the upside to investing in the company was large. Meanwhile, cash on hand was small. Granting options provided employees with the promise of a big future payoff, while costing little in terms of impact on the income statement — thanks to accounting conventions of the day.

In RF Micro's fiscal 2000, subtracting the cost of employee stock options from earnings (along with a few other adjustments) would have dropped profits 36 percent, from $50 million to about $32 million. Dean Priddy, RF Micro Devices' chief financial officer and the fifth employee to be hired at the firm, in an interview did not specifically address whether all those options would have been granted if they had to be expensed. But he did say: "I see why some management teams would like it to be more of a footnote."

In 1998, the adjusted price of RF Micro shares was just more than $1. By early 2000, it was topping $90. Options outstanding during 2000, meanwhile, had exercise prices ranging between 4 cents and $175, with a weighted average strike price of $17.22. For a couple of years, employees holding options to buy RF Micro stock were on the brink of striking it rich. "If [the stock price] appreciates, then the investor is going to be happy. And the employee, too, is going to draw some economic benefit," Priddy says.

Then in the winter of 2000, RF Micro shares began to plunge, following the general southward trend of the technology sector. With shares quickly dipping to about $5, almost all the outstanding options granted to employees became worthless. And RF Micro stock remained mired south of $10 a share for the next few years. With the 2006 adoption of the new accounting rule regarding expensing options, those worthless options would suddenly be costing RF Micro a chunk of profits.

For that reason, RF Micro in 2005 was one of about 900 firms nationwide that accelerated its stock option vesting schedule. By speeding up the vesting period, firms essentially erased them off the books so that they wouldn't need to expense them in their income statements when the time came. There was nothing necessarily sinister about the practice, although for firms that intend to keep on using employee stock options — or substitute some other sort of compensation in lieu of options — it may mean that reported 2005 expenses appear abnormally low and likely to jump up the following year.

In RF Micro's case, all of the accelerated-vesting options were "out of the money," meaning the exercise price was above the trading price at the time. The company vested 10.2 million shares, and in its fiscal 2005 annual report said the move cost it $22.1 million. But again, this charge appeared only in the footnotes, instead of in the main report if they had carried over to the next year. "That was a legitimate way to avoid the expense on those particular options," says Priddy. "We decided it would be a prudent thing to do."

One earnings bullet was dodged, but the new accounting rule loomed. How would RF Micro Devices respond? First, it has begun duly reporting its options expenses in the regular income statement. But it also began doing something else — providing its own version of how investors might view the firm's financial reports. It's called "non-GAAP" results. GAAP stands for Generally Accepted Accounting Principles, and the non-GAAP numbers take out expenses for stock options, as well as some one-time charges. For the firm's second quarter this year, the GAAP results showed a loss of $20 million while the non-GAAP results showed a profit of $23.7 million.

"To the extent that [stock-option expense] are in the GAAP results, it does stand out," Priddy says. "We're less concerned about where it shows up than being able to show the investment community what we believe our core operating results are. That gets to the non-GAAP presentation."

Broad-Based Options

Whether RF Micro Devices provides two versions of financial results or 200 ultimately doesn't matter. The important thing is that a) the market gets the information it needs to properly value the firm and b) the firm's managers and board members recognize the true economic cost of granting options as they go about making decisions about how to deploy the company's assets. The problem with stock options centers more on the latter point.

Kevin Murphy, an economist at the University of Southern California (USC), believes that scores of firms had a blind spot with regards to options, thanks in part to their previous disclosure location in the footnotes, and he has evidence to back that assertion up.

Murphy, along with Harvard University economist Brian Hall, found an enormous spike in the value of option grants during the 1990s. In 1992, the average grant-date value of employee stock options among firms in the S&P 500 was $22 million; by 2000, it was $238 million. But the big story in that growth was who was receiving the options — rank-and-file employees. By 2002, about 90 percent of stock options were granted to employees below the top-executive level.

The thing is, the utility of options among such lower-level employees is limited. Options would seem useful in attracting entrepreneurial, risk-taking workers. But usually only the performance of employees with a lot of responsibility and decisionmaking opportunities can directly affect company stock prices. When options are so liberally given, they can create a free-rider problem, with many employees benefiting from stock price gains that occurred largely because of the actions of others. Also, as a retention tool, options can backfire in times of bear markets, as employees ditch their firms in search of companies offering other compensation packages.

Therein lies the big question: Taking for granted that all of these problems with granting options to lower- and mid-level employees are true, what reason would rational, incentive-minded boards and managers have in lavishing options across the payroll? The only plausible answer is that they regard them as free, or at least as costing less than cash.

"The conclusion that these ... firms will be hurt [by the new rule requiring expensing of options] and not benefited is based on the incorrect assumption that these options are free, or cost very little," Murphy says. "But there's an inherent fallacy in that logic. My own view is that companies are always helped when they make decisions based on the economic cost."

How is it that boards and managers don't seem to recognize the economic costs of options while the market does? The leading hypothesis is that managers don't pay attention to economic numbers because their compensation is based on accounting numbers. Equally, managers perceive that hitting their accounting number targets is key to keeping their stock prices steady and rising. "There's a lot of literature out there that seems to suggest that managers care a whole lot about accounting treatments for various types of things even though the market sees through it," says Guay, the University of Pennsylvania accounting professor. "This whole notion of meeting or beating forecasts has evolved into this complex game of signaling that didn't evolve out of any economic significance."

Economists Hall and Murphy have looked beyond stock options and found other evidence that managers often respond to accounting concerns in ways that seem irrational, citing the 1993 rule change imposing a charge for anticipated post-retirement health care liabilities. Firms predicted that stock prices would fall because of the impact on income, but prices remained the same because the market was already valuing this economic liability — and yet companies still cut back on their retiree medical benefits. Such seeming irrationality remains hard to explain, but it's worth noting that, despite such cases, firms generally behave in ways that are consistent with mainstream economic theory.

Backdating

The historical practice of making options essentially free in accounting terms may be at the heart of one of the more recent scandals engulfing corporate America — options backdating.

Backdating is the term given to the practice of retroactively matching strike prices of stock options so that they correspond to a particularly low price for the company's stock. The result is that employees with backdated options have greater opportunity to enhance their profit from exercising them. Backdating is not necessarily illegal, so long as shareholders are properly informed and earnings are properly adjusted — but in practice few firms seem to have met those requirements.

The vast majority of firms that have announced they expect to restate earnings to reflect backdating of options are in the technology sector, many based in Silicon Valley. Among the more than 100 of those firms is only one in the Fifth District — ePlus Inc., a computer products reseller based in Herndon, Va., according to a *Wall Street Journal* compilation of reports on firms that have disclosed government investigations. The company in August said it would have to account for $3 million in stock option compensation expenses from April 1997 through March 31, 2006, and that further expenses arising from an internal investigation "will be significant."

Erik Lie, a finance professor at the University of Iowa, is one of the leading researchers of the backdating phenomenon. Lie estimates that at least 2,000 firms have engaged in backdating over the years.

Backdating is much less likely to happen today for two reasons. The first is due to a 2002 requirement by the SEC that option grants be reported within two business days. Firms that want to dabble in backdating today have to engage in outright fraud rather than play around the edges of legality as before. "Now you have to come up with one more lie about how you made the grant,"

Views on Stock Options and Reaction to FAS No. 123(R) from Around the Fifth District

"The concept behind using stock options is that it aligns employees' interests with those of our shareholders. As they work to increase the value of the firm, employees in turn are rewarded with the growing value of their stock option grants."

—Linda Brewton, manager, investor relations, Red Hat Inc., Durham, N.C.

"Stock options align well with Sonoco's shareholder interests and provide a good vehicle for employee stock ownership, and until recently had an advantageous accounting treatment ... With the anticipation of FAS No. 123(R) several years ago, Sonoco began to shift more of its incentives at the senior level from stock options to long-term incentive plans based on restricted stock."

—Roger Schrum, director, corporate communications, Sonoco Products Co., Hartsville, S.C.

Since the adoption of FAS No. 123(R), "The substantial majority of employees receiving awards have received restricted stock instead of stock options."

—Katharine Kenny, assistant vice president, investor relations, CarMax Inc., Richmond, Va.

"We are very concerned that the cost of expensing employee stock options would restrict the ability of companies to offer this important benefit in the future ... In addition, we are concerned with the impact the proposal would have on small businesses."

—Steven Anderson, CEO, National Restaurant Association, Washington, D.C.

Lie says. "That may help curb backdating."

Second, some analysts argue that expensing options serves as a deterrent to backdating. If firms had to immediately recognize the cost of granting options, then there likely would have been more scrutiny over the practice of backdating and its accompanying costs. Rebecca McEnally, a director with the CFA Institute, a Charlottesville, Va.-based nonprofit financial markets organization, says the requirement that firms expense options is one of several important changes that will ease the problem. "Both preparers of financial statements and auditors pay too little attention to the numbers that are reported in the footnotes," McEnally says. "If it's not expensed, it looks like a free good at the time, even though it is costly to investors."

Future Options

But what place will garden-variety employee stock options hold in the future? The evidence so far is that companies are paring back their employee option grants. Murphy, the USC economist, says his recent surveys have found that while in 2001, firms were granting 2.6 percent of their compensation in the form of stock options, in 2005 it was down to 1.3 percent. "There's a tremendous amount of evidence that managers and directors respond to changes in accounting rules," Murphy says.

In other words, now that there is both an economic and accounting cost to be reported, employee stock options seem unlikely to be offered in the volume they were in years past. When it became obvious that stock option expensing would become the norm, many firms began cutting back on their use. Perhaps the most famous firm to swear off options is Microsoft. Since 2003, the Redmond, Wash., company has only made outright stock grants to workers. In firms where stock options continue to be issued, Murphy and Hall believe, they are "likely to be reduced and concentrated among those executives and key technical employees who can plausibly affect company stock prices." That category would include young and small firms, as well as possibly struggling firms for which employee loyalty and high performance is particularly important.

Of course, for firms that believe stock prices already reflected the cost of options, then reporting them should not matter much, says the Cleveland Fed's Haubrich. "So if options are the proper compensation tool, their use should continue." In Greensboro, RF Micro Devices remains a believer in stock options. Last year, the firm's shareholders approved a plan that canceled 9.4 million old options and awarded half as many new ones. The old options were worthless, with strike prices as high as $87.50 at a time when RF Micro shares were trading well below $10. The newly issued shares (one awarded for every two canceled shares) came with much more friendly exercise prices of $6.06 and vesting over two years.

Thus, options remained a part of RF Micro's compensation program. The firm continues to believe in the utility of stock options, so much so that to this day, every new domestic employee at RF Micro Devices gets an award of stock options upon hiring. The firm has 2,000 domestic employees, so this is no trifling matter. It speaks to management's philosophy about employee impact. As CFO Priddy says, "We believe that every single employee has the ability to improve the long-term operating results for the company, whether it's someone working in wafer fabrication to help improve the product, or if it's a person in customer service. To us, all of our employees are valuable assets, and we believe these employees recognize the value of our stock options."

In a way, one can think of RF Micro Devices' enduring faith in stock options as a natural experiment: How much can a firm rely on stock options to motivate employees in a time when granting them now carries immediate and perhaps more obvious costs? Priddy is optimistic. "It's something we certainly continue to plan on doing. I really don't know if this company as we know it today would be here without stock options," he says. "That's how powerful an incentive tool I believe they are." **RF**

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Phoning It In

Telecommuting hasn't become the commonplace work alternative its advocates anticipated. Still, the flexibility it offers has helped a significant number of companies and employees

BY CHARLES GERENA

Three years ago, Malcolm McLeod didn't know how much longer he could endure his daily commute. The 60-year-old environmental engineer remembers leaving his home in Caroline County, Va., at 4:30 a.m. every morning so he could drive to the nearest Virginia Railway Express station, catch a train, and get to his office in Washington, D.C., two and a half hours later. In the evenings, he would leave work at 4:15 p.m. and get home well after 6.

Sure, McLeod could have moved, but he preferred a less urban environment and wanted to remain in the farmhouse he had purchased and renovated 30 years ago. He also could have retired or looked for employment closer to where he lived, but he had already put in several decades at the U.S. Army Corps of Engineers and generally found his job rewarding. The agency didn't want McLeod to leave, either — he manages the decommissioning of three nuclear plants built more than 40 years ago by the Army Corps, plants he knows inside and out since he helped engineer them.

So, several days a week McLeod trades his desk in D.C. for one of the workstations at the Fredericksburg Regional Telework Center, located in an old shopping center off Interstate 95 and just nine miles from his house. "Depending on how many stoplights I hit along Route 17, it takes me about 10 to 15 minutes to get to the center," he describes. For McLeod, working from the center part-time has been a lifestyle change. "I would have seriously considered retirement unless I was able to do this."

The Fredericksburg center is one of 14 locations operated by the General Services Administration for federal employees like McLeod who don't drive to their place of employment every day. Instead, they "telecommute" or "telework," using communications technology to perform their jobs remotely on a regular basis, usually from home or a location that's nearby. The government agencies pay a daily rate of $25 to $49 for every employee based at a telework center, as well as foot the bill for long-distance calls.

From the outside, the Fredericksburg center looks like any other plain storefront. Inside is a microcosm of the typical office environment, accessible 24 hours a day, seven days a week with the swipe of a card at the front door. Thirty workstations are scattered around the open floor plan, each with a telephone and a desktop computer networked to the outside world. Telecommuters have access to a conference room for meetings and locked cabinets for storing confidential paperwork.

McLeod and the other regulars at the center get to use a reserved workstation. Some personalize their space like Mary Ann Delaney, a national account manager for military construction at the Army Corps. Delaney, who has worked at the center since 1994 and spends three days a week here, likes to display pictures of her dog.

"It is completely seamless," Delaney says, using a word that McLeod also used to describe his current work arrangement. "I deal with people in Europe, I deal with people at the home office, [and] I deal with people at the Pentagon. It's amazing."

Despite these and other success stories, the Fredericksburg center was pretty quiet on a fall Tuesday morning. Typically, it's booked at 60 percent of capacity on Tuesdays, notes Jennifer Alcott, who manages this facility and two others in Woodbridge and Stafford in Northern Virginia. Overall,

ILLUSTRATION: PHOTOSPIN AND AILSA LONG

the utilization rate of the 14 telework centers is about 55 percent, amounting to 469 federal and nonfederal employees.

This trend mirrors what has happened in the private sector — telecommuting hasn't been widely adopted despite efforts to encourage its use since the 1970s, frustrating its proponents. While this arrangement gives businesses and workers greater flexibility, the benefits accrue to only a particular type of employee doing a certain kind of work in certain industries. Just because people can do a variety of jobs from a laptop on their kitchen table doesn't mean that telecommuting is automatically the most economically rational choice for everyone.

Winning Converts

Those who have studied telecommuting or advocated its adoption say that the ranks of telecommuters have grown over the long term, with a leveling off occurring after 2000. But don't try to pin them down to exact numbers.

"Firms do not need to report teleworkers to anyone, nor do individuals need to do so," says Diane Bailey, a professor of management science and engineering at Stanford University who has studied telecommuting. "Additionally, definitional problems about who to count … make counting difficult."

Instead of braving the congested roads of Northern Virginia, Juliet McBride and Malcolm McLeod telecommute from the Fredericksburg Regional Telework Center.

A variety of government surveys include data on people who work from home, from the U.S. Census Bureau's American Housing Survey to the Department of Transportation's National Household Travel Survey. Nonprofits like the International Telework Association and Council (ITAC) have done surveys too. The problem is some of them count a person as a telecommuter if he works outside of the office full-time, while other surveys also count people who telecommute irregularly, work off-hours at home, or are home-based entrepreneurs or consultants who rarely spend time in a traditional office.

With these limitations in mind, the most recent estimates from the Bureau of Labor Statistics and ITAC place the number of people who telecommute at least once a week at 21 million to 22 million, or 15 percent to 16 percent of the total work force. These numbers are higher than estimates calculated in the 1990s, but still less than what some experts had projected.

Lawmakers have been trying to encourage broader use of telecommuting to reduce energy consumption and improve air quality. Reducing traffic in metro areas also has become a way to increase transportation capacity without building more roads, which can be politically difficult to accomplish, and to improve quality of life. In both cases, growth would be encouraged in communities.

Therein lies a problem with using telecommuting and other alternatives like mass transit and carpooling to reduce traffic. If congestion eases in a metro area, more people want to live there. A similar phenomenon occurs when new roads are built — traffic problems are relieved in the short run, but this induces more people to drive, clogging the roads with traffic once again.

"You just bring more people into urban areas. The physical number of people would be the same, or perhaps larger," notes economist Elena Safirova. Based on her research at Resources for the Future, a Washington, D.C.-based think tank, Safirova says that telecommuting programs cannot be relied upon to sustain the reductions in congestion they initially achieve.

In addition, studies on the transportation impact of telecommuting have found reductions only in daily trips and vehicle miles traveled on an individual basis. "Thus, although an individual telecommuter may experience a sharp reduction in [vehicle miles traveled], total benefits depend on how many people are telecommuting and how often they are doing so," wrote Safirova and Margaret Walls in a 2004 paper.

Even as the technology has emerged to allow people to work remotely and independently, embracing telecommuting still requires a major shift in thinking for both employers and their employees. The benefits have to outweigh the costs to make it worth the change.

The Future of Human Resources Management?

Advocates point to several potential benefits of telecommuting for employers. Number one on their list is that it increases productivity.

By allowing employees to telecommute, companies can reduce absenteeism and tardiness. Instead of trying to come to the office when an overturned tractor trailer has shut down the interstate, employees can stay home and work. Or, when they have a doctor's appointment or a school emergency close to home, telecommuters don't have to take as much time off.

Another way telecommuting could benefit companies is to help match jobs with workers. "Employers [that offer telecommuting] have access to a wider work force than they would if they relied on only the local work force," Safirova explains. "Some people don't want to live in large cities," but they might work for companies in those locations.

PHOTOGRAPHY: CHARLES GERENA

Similarly, the flexibility provided by telecommuting can help a company retain employees, especially in tight labor markets. Take ORC Macro International, for example. The management consulting firm's division in Bethesda, Md., started offering telecommuting in the late 1990s to hang on to its data collection and dissemination workers who were moving away.

"These people were going to be hard to replace," recalls Guy Garnett, the division's vice president of network systems and services. "They knew how we work and the projects, so they were more valuable than a new hire." One employee was married to a member of the military who was posted to Bosnia. When she decided to go with him, the company allowed her to telecommute from six time zones away.

Today, ORC's Bethesda employees telecommute from Massachusetts, Pennsylvania, and even Eastern Europe. Last April, Vladimer Shioshvili started telecommuting from Georgia — the former Soviet Republic, not the Peach State — to be closer to his family. The senior programmer/analyst works from a small room in his girlfriend's apartment, outfitted with a computer desk and chair, a laptop provided by the company, and a printer, along with a view of the busy streets below.

"It can get a little loud sometimes," Shioshvili says, and it took awhile to get used to the eight-hour time difference. But there have been no problems with his intercontinental telecommute so far, other than an occasional dropped call.

Finally, telecommuting promises to reduce a company's need for office space. Jennifer Alcott, the Fredericksburg telework center manager, points to the U.S. Patent and Trademark Office as an example. According to Alcott, the PTO will have to hire about 3,000 examiners within the next few years. This influx of new hires will require doubling the size of its campus in Alexandria. To lessen that expense, the agency is expanding its 10-year-old telecommuting program.

Don't Move My Cheese

Despite these and other fruitful implementations of telecommuting, there are many managers who remain unconvinced. They need hard evidence that increased productivity and cost savings will compensate for the startup and ongoing expenses of a telecommuting program.

Claims of improved productivity have been based largely on case studies of individual companies and surveys, both of which are subjective measures that have their limitations.

"You can measure the productivity impacts of telecommuting as well as you can measure [white-collar] productivity generally," says Patricia Mokhtarian, director of the Telecommunications and Travel Behavior Research Program at the University of California at Davis. "It is pretty hard to quantify," though it can be done in

Government Sweetens the Telecommuting Pot

Since the Arab oil embargo in 1973 and 1974, government officials on the federal level have been nudging private companies to offer telecommuting as a way to reduce energy consumption. Later, Clean Air Act mandates forced states to take a hard look at ways to get cars off the road, including having more people work from home. In both cases, the results of their efforts have been mixed.

Congestion and air-quality concerns are what drove local governments in the Washington, D.C., region to include telecommuting as part of their regional transportation planning. "We were designated as a severe non-attainment area for nitrogen oxides and volatile organic compounds by the EPA," says Nicholas Ramfos, who manages the telecommuting initiatives of the Metropolitan Washington Council of Governments. In order to receive federal transportation funding, the region had to show it was taking steps to reduce those pollutants.

Government programs support telecommuting for another reason — to open doors to employment for those who have difficulty finding and keeping a job. These include the homebound (i.e., stay-at-home parents, the physically handicapped, and the elderly), spouses of military personnel who are subject to relocation at any time, and residents of isolated rural areas.

Since 2001, Telework!Va has provided incentives for Virginia businesses to establish or expand telecommuting programs. The state-funded program offers a maximum of $3,500 per employee for up to 10 employees to help cover program expenses over a two-year period. Reimbursable costs include leasing office equipment for home use, renting space at a telework center, and consulting and technical services.

So far, two dozen companies in the Northern Virginia, Richmond, and Hampton Roads regions have received $302,000 in grants, the majority going to firms closest to the nation's capital. That is just a fraction of the $3.2 million budgeted for the program by the General Assembly.

Through its Telework Partnership with Employers program, Maryland had offered state-funded grants of up to $15,000 to pay for a consultant to assess a company's potential for telecommuting, then develop and implement a program. Russ Ulrich, who coordinates air-quality outreach programs at the Baltimore Metropolitan Council, says that most of the money set aside by lawmakers for the eight-year-old program has been spent. Still, telecommuting was slow to catch on in the Baltimore metro region.

"There was a lot of skepticism, especially for those businesses that had never heard of teleworking and had no firsthand experience with it," Ulrich notes. "The idea of working remotely wasn't fully understood." Even though the regional economy is changing, it still has a "blue-collar mentality." Employers expect their workers to show up at their place of business, and for many of the region's top industries, telecommuting simply is not feasible. — Charles Gerena some industries like telemarketing and sales.

Furthermore, actual improvements in the productivity of telecommuters may be limited to those who are already disciplined, hard workers. Relatively unproductive workers don't magically become "Employees of the Month" if they are allowed to telecommute. These employees need monitoring, which telecommuting makes more difficult. Productivity gains are also constrained when people telecommute only part-time.

Cost savings from reducing office space have been documented. The caveat, in this case, is that the company must achieve a critical mass of teleworkers in order to realize those savings. "You've got to have enough people out of the office for enough days during the week that you can reconfigure your office space," says Harriett West, a senior manager at Clifton Gunderson. She has tried to develop a telecommuting specialty practice at the accounting and business consulting firm since 2001, but hasn't had many takers.

While the benefits of telecommuting seem unclear, many managers are concerned about what might be lost if employees are allowed to work from anywhere. Some say it would be harder to ensure that telecommuters are doing their jobs. Others don't want to lose the fruits of collaboration.

Mokhtarian says academic studies have demonstrated the value of having workers physically present. While information technology is supposed to make working remotely as good as being in the office, managers lose the body language, the ease of getting people together, and the side conversations that convey a lot of meaning and information. "In many cases, there is a legitimacy to the idea that we need to be face to face," she adds.

There is also the monetary cost of creating a virtual office. While 42 percent of adults have broadband Internet access at home, the company or the worker has to be willing to pay for connecting those households without it. In addition, telecommuters need the proper equipment in place, from fax machines to PCs with secure network access. "For some federal agencies and contractors, security for remote access is a huge concern," says Nicholas Ramfos, director of the commuter program at the Metropolitan Washington Council of Governments.

Such costs vary from company to company, but a telework study done for the Virginia Department of Transportation in 2001 arrived at some general estimates. For a program with a minimum of 50 participants telecommuting at least twice a week, startup costs were pegged at $6,000 for home-based telecommuters and $9,500 for those who work at a telecenter. The annual recurring costs ranged from $2,500 to $3,500 per person. (The General Services Administration's cost estimate for home-based telecommuters also falls within this range.)

Finally, legal issues have to be addressed. Most states — including Virginia, West Virginia, and the Carolinas — reserve the right to tax a company's income if it has workers telecommuting from those states. Then, there are liability questions: What is the employer's obligation to ensure that the telecommuter's home office adheres to workplace safety standards? Do union contract requirements apply to employees who work at home? Each question can be addressed in the telecommuting agreement signed by the employer and employee, but every additional provision adds costs to the arrangement and undermines its flexibility.

The Employee Perspective

Managers aren't the only ones who weigh the potential benefits and costs of telecommuting. For employees, the advantages of working from home have to be worth the effort.

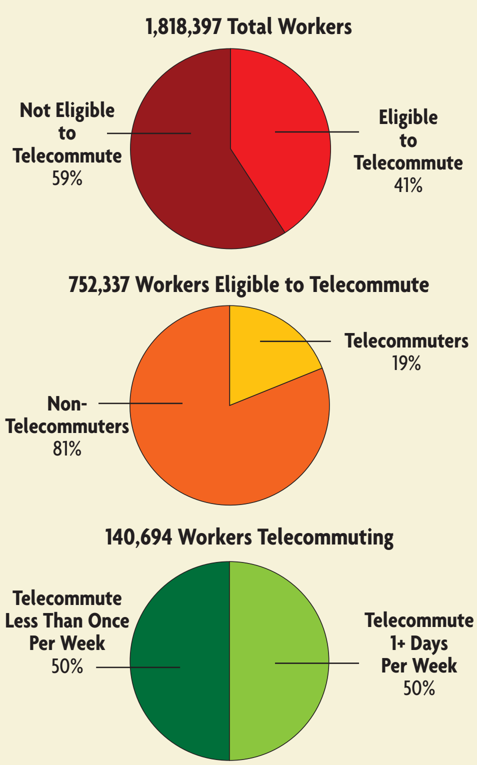
The main promise of telecommuting for individuals is the flexibility it offers for balancing work and family duties. In her 2002 review of previous telecommuting research, Diane Bailey found that women, dual-career couples, and families with younger children often cite this benefit. Additionally, Bailey says telecommuters benefit from greater autonomy and the time and cost savings of working from home.

Still, telecommuting may not yield significant benefits for everyone. For example, some people don't mind having a long journey to work. One study done by Patricia Mokhtarian in 2000 found that people actually derive some benefit from a commute of moderate length — among 1,300 workers surveyed in the San Francisco Bay Area, the average commute desired was 16 minutes.

Why? Workers may need the journey between home and work to prepare for the workday ahead or to unwind before walking through the front door. "This is the time

A Small Slice of the Work Force

Among the 82 federal agencies surveyed in 2004, only 4 percent of their 1.8 million employees telecommuted at least once a week.



SOURCE: "The Status of Telework in the Federal Government," U.S. Office of Personnel Management, December 2005 to decompress and change roles. It is a transition period between one role in your life and another," economist Elena Safirova notes.

Some workers believe they are judged by how much "face time" they have with management. Therefore, their chances of promotion would be hurt if they become less visible by telecommuting. Among 1,320 executives surveyed by recruitment firm Korn/Ferry International in late 2006, about 61 percent thought telecommuters are less likely to advance in their careers compared to employees working in traditional office settings.

"Even though workplace technology has made big leaps forward compared to 20 or 30 years ago, the general mentality of the workplace is still the same: out of sight, out of mind," Safirova says.

In fact, this could be more perception than reality. Consultant Harriett West says workers allowed to telecommute are usually the ones that management thinks are the most trustworthy and productive. Korn/Ferry's survey confirms her assessment: 78 percent of respondents said telecommuters are either equally or more productive than their office-bound colleagues.

Finally, some telecommuters may have trouble stepping away from their desk at the end of what otherwise would be the normal workday. "If you wake up at 2 o'clock in the morning with an idea, the work is right here," West explains. "Some people need more of a barrier between work and home."

Reality Check

Like videoconferencing, telecommuting isn't right for every company, every job, or every person.

Service firms that focus on the creation, distribution, or use of information are a natural fit for telecommuting. This includes call centers, computer software firms, marketing organizations, and corporate support operations like payroll and human resources. Also, occupations where most of the work occurs outside of the office anyway are better suited for telecommuting, such as sales and auditing.

In contrast, workers at manufacturing plants, mines, and building maintenance firms have to do their jobs on-site. In general, most of the production work force will probably never telecommute. Neither will those occupations where face-to-face interaction is essential to the job.

If the Telework Exchange and other nonprofit groups promoting telecommuting had their way, there would be more bumper stickers like this one on cars.

Herman Miller, which offers workspace consulting services in addition to producing office furniture, outlined in a 2001 white paper what it considers to be the ideal telecommuting job: "Work that can be performed off-site is generally explicit enough to be achieved without further explanation or direction, paced and controlled by the worker, conducted over the phone," and involves soft skills like reading and planning. A Department of Labor report published in 2000 noted that telecommuting works best for jobs that demand a high degree of privacy and concentration, are predictable, and information-based.

Rita Mace Walston, general manager of a nonprofit advocacy group called the Telework Consortium, adds that people who are newcomers to their job, the industry, or the world of work in general may need a little seasoning in the office before they are ready to telecommute.

In general, the best telecommuters are self-directed and self-disciplined. These are traits that Vladimer Shioshvili possesses, and they help make telecommuting from Eastern Europe work for him and his employer, ORC Macro International.

"I can motivate myself, most of the time," he says, although keeping himself on task can sometimes be a challenge when there are distractions in his apartment. He continues to work late once in a while, putting in more than eight hours a day like he used to back in Bethesda.

To stay in the loop, Shioshvili uses a messenger service, e-mail, and phone conversations in addition to instant messaging. Also, because the company has several dozen telecommuters, project teams hold biweekly conference calls to supplement physical meetings. "Sometimes, it doesn't feel like I'm that far away." **RF**

PHOTOGRAPHY: COURTESY OF TELEWORK EXCHANGE

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Opt in or Opt out?

Automatic enrollment increases 401(k) participation

BY BETTY JOYCE NASH

Planning for retirement is something we would expect "rational economic actors" to take great care in doing. But the Federal Reserve's 2004 Survey of Consumer Finances shows the typical household approaching retirement with less than $30,000 in financial assets outside of employer-sponsored plans. And people aren't saving enough in those plans. This is not the sort of behavior one would expect from forward-looking human beings.

Society could be headed for an expensive ride if the workers of today don't squirrel away money — early and often. Life expectancy can leave, on average, about 20 years in retirement, and someone will have to pay for it. With guaranteed company pensions becoming less common and the arithmetic problems of Social Security well publicized, today's workers need a retirement lifeline. The risk and responsibilities of retirement rest on individuals' shoulders.

"Companies are moving away from defined benefit plans [guaranteed pensions] and moving toward [defined] contributions, the 401(k), in which what you get depends very much on what you as an individual do while you're working," says Brigitte Madrian, a Harvard University economist who has studied plan designs and savings outcomes.

But 401(k) decisions require a chain of financial moves that many workers avoid. About one-fifth of eligible employees don't even take the first step — signing up.

To remedy this, automatic enrollment in 401(k) plans is gaining traction among employers. Instead of having to sign up, employees are enrolled by default but retain the right to opt out. Participation results among firms that have tried it have risen as high as 90 percent, in some cases. It's especially effective for increasing participation of women and minorities.

Traditional neoclassical economics can't explain the success of automatic enrollment. Why would it improve enrollment when the choices are the same? Rational people should participate in roughly the same numbers regardless of whether the default is opt in or opt out. In explaining this paradox, economists are turning to behavioral economics.

Human Nature and Economic Man

Basic neoclassical economic theory suggests that people weigh costs and benefits, making decisions that are in their best interest. They save and spend according to need over a lifetime. Some people, for example, may count on that rich uncle, or other savings vehicles, especially home equity. And 401(k) plan contributions are deducted before taxes, a great benefit to higher-income earners, but not so much for low-wage workers. So, for some people it could be rational to forego contributions to a 401(k) plan, especially since tax rates and/or brackets may be higher at retirement than now. (For low- and moderate-income people, some research shows that a 401(k) plan may raise lifetime taxes and lower lifetime expenditures.)

Still, surveys indicate that retirement preparation may be inadequate to sustain retirement. The Center for Retirement Research at Boston College reports that 35 percent of

PHOTOGRAPHY: PHOTODISC AND PHOTOSPIN

households aged 55 to 64 have no pension, only Social Security. With 401(k) becoming the new pension, policy experts worry that this group of insufficient savers could grow. Mainstream economics hasn't fully explained nor found the cure for low savings.

The life-cycle theory, for example, assumes that people increase savings as they age. But economists Lawrence Summers of Harvard University and Christopher Carroll, now with Johns Hopkins University, suggested in a 1989 paper that consumption, rather than being smoothed over the life cycle, instead tracks income. And it would seem that aging baby boomers would be beefing up the national savings rate, but the rate continues its decline.

"Unfortunately, many years of concentrated attention on this issue by policymakers and economists have failed to uncover a silver bullet for increasing household saving," Fed Chairman Ben Bernanke said recently in a speech. While no silver bullet, automatic enrollment in 401(k) plans may be a step in the right direction.

Whereas neoclassical economics generally models humans as wholly rational beings, behavioral economics assumes some flaws. Incorporating psychological insights, behavioral economics finds human decisions sometimes fraught with error and systematic bias: People have trouble making long-term decisions and place more weight on present circumstances than those in the future.

Behavioral economists Richard Thaler and Shlomo Benartzi observed in 1981 that actual household behavior veers from the life-cycle theory for many reasons. People might calculate needs incorrectly, and have trouble delaying gratification. For example, people born between 1931 and 1941 who saved with old-fashioned pension, Social Security, and home equity — vehicles requiring precious little willpower — tend to be adequately prepared in retirement, according to economists Alan Gustman and Thomas Steinmeier of Dartmouth College and Texas Tech University, respectively. But workers today need to act: calculate future expenses, save, and invest for adequate asset accumulation. That is a tall order for people who place enormous weight on current consumption, and an especially tall order for people with little or no financial knowledge.

Those decisions require self-control and savvy as well as the ability to act rather than procrastinate. As Thaler and Benartzi write, "determining the appropriate savings rate is difficult, even for someone with economics training."

Thaler and others have identified the human tendency to postpone unpleasant tasks such as saving or dieting rather than spending or eating. Using such human characteristics to advantage, automatic enrollment can increase savings somewhat painlessly. Thaler and Benartzi point out: "Standard economic theory would predict that this change would have virtually no effect on saving behavior. The costs of actively joining the plan (typically filling out a short form) are trivial compared with the potential benefits of the tax-free accumulation of wealth." Yet automatic enrollment has clearly added workers to 401(k) plans.

Benefit vs. Contribution

Guaranteed income streams, also known as defined benefits, have been drying up. Employers over the last 25 years instead have offered 401(k) plans as an alternative. Only about one in five employees today is covered by traditional pensions compared to the nearly two-thirds so covered in 1983. Moreover, one in four workers were offered both a pension and participation in a 401(k) plan in 1983, but by 2004 that number had fallen to 17 percent. Overall, 63 percent of workers in 2004 had access to a 401(k) plan.

But 401(k) plan participation isn't what it could be, especially if compared with the traditional pension that usually covered every employee at a firm. About one in five eligible employees fail to sign on to 401(k) plans, with younger workers less likely than older workers to join. Of participants, only about 11 percent contribute the legal maximum. Many, about half of U.S. workers, don't kick in enough to maximize the amount that some employers match, either, essentially refusing "free money." In some cases, a lot of free money.

David Wray of the Profit Sharing/401(k) Council of America (PSCA) says surveys of his members indicate automatic enrollment can raise participation from its current 70 percent to 75 percent to more than 95 percent. At white-collar firms with educated employees, "We had one company, a consulting company, automatically enrolled with 98 percent participation," he notes. Such high enrollment rates are more likely to occur in smaller firms, because many large firms still offer guaranteed pensions, which typically means that their 401(k) participation rates are lower than smaller firms.

By 1998, Internal Revenue Service rulings cleared the way to promote automatic enrollment into 401(k) plans, giving employees the choice to opt out rather than opt in. "The presumption was very much, 'We will set up these plans, the people who need them will use them, and if we set up financial education they will make smart choices and everything will be hunky dory,'" Madrian says. That worked fine for some, yet many are uncomfortable with financial choices. Researchers like Madrian have found that firms can affect savings outcomes significantly with automatic enrollment, sensible asset allocation, and escalating contributions.

Opt Out

The Pension Protection Act (August 2006) clarified points about employers' liability for investments, among other murky areas, giving auto-enrollment a leg up. Mark Iwry, who is a nonresident senior fellow at the Brookings Institution, was the benefits tax counsel at the Department of the Treasury when the concept surfaced.

He recalls asking, "Why do we like defined benefits so much? And if they're not going to be around, let's transplant those organs into 401(k)s." Automatic enrollment fit the bill. The policy would cover more moderate- and low-income workers and ease the pain of the disappearing pension.

Automatic enrollment for sure works, and it's largely because of the human tendency to procrastinate, say behavioral economists. People not only put off signing on to their 401(k) plans, they procrastinate when it comes to changing allocations and contribution levels. Economists Madrian, David Laibson, and Andrew Metrick found 401(k) participation rates at three firms exceeded 85 percent under automatic enrollment. Before, participation ranged from 26 percent to 43 percent after six months at the three firms and 57 percent to 69 percent after three years.

"Even though they could opt out, few did," Madrian notes. "The traditional way companies have gone about offering contribution plans have not worked well for those individuals who don't feel comfortable making financial decisions. And there are very small things companies can do that can have a huge impact on outcomes we observe, either for good or bad."

Default Rates, Allocations

But even automatic enrollment isn't a retirement savings panacea. Human inertia exerts so much power that most people don't ramp up contribution rates over time nor do they tweak investments to suit their stage in the life cycle.

In a 2001 paper, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," Madrian and Shea point to about a 48 percentage point increase in participation among new hires and an 11 percentage point increase overall at a large health services firm 15 months after enrollment. Among women, participation rose from 36 percent to 86 percent; for Hispanics, from 19 percent to 75 percent; and for those earning less than $20,000, from 13 percent to 80 percent.

Automatic enrollment succeeds in enrolling lower-income and minority workers because "these are the groups who have the lowest comfort level with financial matters," she says. "They have less education, less personal experience. They also have a lower sense of urgency."

Because employees are passive when it comes to participation, plans need to be designed with behavioral traits in mind, Madrian and her co-authors James Choi, David Laibson, and Andrew Metrick also noted in another paper, "The Path of Least Resistance in 401(k) Plans."

Money tends to stick where it lands. In that study, 65 percent to 87 percent of participants stayed with the company specified default (2 percent to 3 percent) and remain in default funds, typically conservative. That percentage slowly declined, but even after two years, 40 percent to 54 percent still clung to the default. The fear is that auto-enrollment, as useful as it has become, may drag down retirement savings if default contribution rates are too low. Some employees might otherwise have selected higher contribution rates. The benefits of higher participation rates could be offset by low contribution rates and default allocations if they are too conservative.

"Employers can exert a strong influence on savings and investment. They could adopt automatic enrollment with aggressive defaults. Also they could automatically roll over balances of terminated employees, choose a higher match threshold to motivate higher savings rates, and they could offer well-thought-out investment options," Madrian notes.

Choice is Hard

Decisionmaking can be tough. Information may be so abundant that people feel paralyzed to act. (An example: In one study, sales fell sharply when customers had 24 jars of jam to choose from instead of only six.)

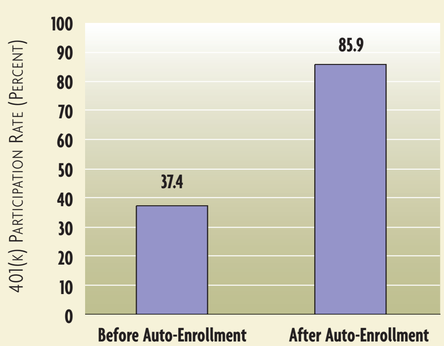
Less is often more when it comes to information: People use information when it isn't too costly for them in terms of time and money, say Julie Agnew and Lisa Szykman of the College of William and Mary. They examined how similarity of plan choices, as well as display of choices, "lead to varying degrees of information overload and the probability of opting for the default."

The authors controlled for the financial aptitude of participants and found that people who were less sophisticated financially opted for the default more often — 20 percent compared to 2 percent — than people who possessed more knowledge about financial matters. Fewer investment choices eased the pain of too much information but only for those with above-average financial knowledge. Even changing the way information was presented, by making it easily comparable, or reducing choices didn't ease "information overload" for those who weren't financially grounded. "The results of this paper support the move away from offering 'one-size-fits-all' defaults," write the authors.

The Buy-In: Automatic Enrollment

The PSCA's David Wray, who surveys his 1,200 members (with a total of 5 million employees) annually about profit sharing and 401(k) plans, found in 2005 that nearly 17 percent of the 1,106 firms responding offer automatic enrollment for new hires, up from 10.5 percent in 2004 and 8.4 percent in 2003. Among the larger companies, with at least 5,000 employees, 34 percent offer automatic enrollment.

Automatic Enrollment and 401(k) Participation: Evidence From Recent Hires of a Fortune 500 Firm



SOURCE: Madrian and Shea, 2001

Benefits giant Hewitt Associates' 2005 biennial survey of more than 450 firms found one in five automatically enrolled employees in 401(k) plans compared to 14 percent in 2003. One in four firms provided automatic rebalancing of accounts. Nearly 20 percent of companies either offer or planned to offer escalation features.

Many firms in the Fifth District offer or plan to offer automatic enrollment, according to Amy Reynolds of Mercer Human Resources Consulting. The Pension Protection Act will definitely increase auto-enrollment, she predicts. "For employers who might have been on the fence, the [Pension Protection Act] has endorsed automatic enrollment," she says. "Now it is part of any conversation we have with plan redesign."

Scott Barton, who manages the retirement plan for plumbing wholesaler Ferguson Enterprises, based in Newport News, Va., says automatic enrollment has been a feature since he was hired in April 2006. The default contribution rate is 2 percent, allocated to the guaranteed income fund. While he isn't sure about participation rates before automatic enrollment, currently they are about 89 percent. And automatic escalation is a possibility down the road.

Blue Cross Blue Shield of North Carolina began automatic enrollment last year for its work force of about 4,100, the majority of whom are women. While participation rates were good, about 70 percent, now more than 90 percent of employees are part of the 401(k) plan.

Larger firms have tended to move more quickly to automatic enrollment. For example, Michelin North America employs more than 7,600 people in South Carolina. Michelin started automatic 401(k) sign-up for employees at 3 percent in January 2005. Since then, fewer than 1 percent of new hires have opted out, according to Lynn Mann, public relations director.

Thaler and Benartzi developed a plan whose name uses the human tendency to procrastinate. It's called "Save More Tomorrow." Everyone wants to save tomorrow, just don't ask them to do it *today*. The plan extends the idea of automatic enrollment by escalating contributions as employees' wages rise. Because the plan links the savings to employee raises, they don't feel the pain of reduced take-home pay. In its first implementation, more than 80 percent of those offered the plan signed up, increasing savings rates from 3.5 percent to 9.4 percent. After two more years those employees were saving 13.6 percent, nearly four times the previous level.

As automatic enrollment sets in, escalating contributions are the next step, and both are poised for growth, says Wray of the PSCA. An added bonus for firms to use automatic enrollment and escalating contributions lies in the "nondiscrimination" testing required by federal pension laws. Savings rates between top earners and others in the firm can't differ by more than 2 percent. Because automatic escalation affects low- as well as high-income earners, the new Pension Protection Act eliminates discrimination testing if employers use the tool. That may be incentive enough, Barton says, for his company to implement the idea.

Automatic enrollment's success at adding people to 401(k) rolls hasn't been widely criticized, according to Madrian. "The criticisms have been more along the lines of the extent to which it is 'paternalistic' and whether that is appropriate." Richard Thaler has dubbed it "libertarian paternalism."

And even mainstream economists such as Eugene Fama of the University of Chicago, well known for his work in the "efficient markets" tradition, acknowledge the role of the behavioralists in raising participation with automatic enrollment. While he's not well versed in the literature, he says "hearsay suggests that they have it right." **RF**

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Bringing in the Unbanked

Banks are increasingly turning their attention to Hispanics without bank accounts

BY VANESSA SUMO

Telenovelas, or Spanish-language soap operas, are wildly popular among Hispanics. They typically tell the story of a poor but beautiful girl who falls in love with a rich, handsome young man, and the story unfolds with every design imaginable to keep them apart, usually plotted by the fellow's scheming family and ex-fiancé. Telenovelas have such a fervent following that when BB&T Corp. decided to produce a set of tapes for its Hispanic banking customers, it made sense to follow this genre.

Except that the heroine of BB&T's telenovela series, Beatriz Bienvenido Torres, or "Bibi," is far from being love struck. Bibi, a long-time resident of the United States and a BB&T Bank employee, is a trusted friend of recent immigrants Juan and Maria Perez. The series is about the couple's adventures of living in a new country and how Bibi is always on hand to give them advice — from how to call 911 to how to get a mortgage. The tapes are distributed through nonprofit organizations such as Latino advocacy groups and are available at the bank's branches.

BB&T is just one of the many banks that aim to bring the "unbanked"— those who do not have bank accounts — into the fold. Who are the unbanked? About 46 percent of blacks and 34 percent of Hispanics born in the United States are unbanked compared with 14 percent of whites, according to a Kansas City Fed report. Among immigrants, 53 percent of Mexicans and 37 percent of other Latin American immigrants are unbanked, compared with 20 percent of immigrants from Asia and 17 percent from Europe.

People who forego bank accounts — regardless of whether they are white, black, Hispanic or any other ethnic group — generally have low incomes. There simply isn't much left over for savings at the end of each month, and the cost of a bounced check sometimes doesn't make a bank account worthwhile. For these people, payday lenders and similar organizations present an attractive option. But there are factors that set unbanked Hispanics apart from the rest. In particular, many are recent immigrants, a significant number are undocumented, lacking in English proficiency, and they come from countries where banking systems have not been terribly stable.

Hispanics have been getting a lot of attention from banks in recent years because of their rising presence: They are the largest and fastest-growing minority group in the United States, now outnumbering blacks. When the U.S. population topped 300 million in October, 36 million of the most recent 100 million additions were Hispanics.

In short, this is a big market, and banks would be missing a tremendous opportunity if they ignored it. A 2004 Federal Deposit Insurance Corp. (FDIC) report notes,"More than half of all U.S. retail banking growth in financial services during the next two decades will originate from the growing Hispanic market."

The possible benefits are plentiful for the unbanked too. Safety is important since the unbanked often carry around large amounts of cash, making them vulnerable to theft. And as they develop roots in the United States over time, their financial needs will likely expand. "What is being understood today is that most people who come to this country end up staying. [They] have a long-term interest in the country. Sooner or later they're going to want to buy that house ... to buy that car, and at some point they will need a bank to do that," says Dan Tatar, an economist with the Community Affairs Office at the Richmond Fed.

As Hispanics weigh the perceived costs and benefits of banking, they may sensibly decide to shy away from banks. If banks want their business, then they must convince the unbanked that the actual benefits are larger, and the costs smaller, than perceived, and that there are gains from this trade. Understanding the reasons why

PHOTOGRAPHY: GETTY IMAGES

Hispanics are relatively unbanked is an important first step. But equally important is understanding that even BB&T's Bibi may find it difficult to overcome Hispanics' aversion to banks.

Understanding the Unbanked

Remittances and check cashing are two of the most essential financial transactions that Hispanics, especially immigrants, regularly make. Although banks usually offer these services at much lower fees, most immigrants still rely on alternative financial institutions like check cashing outlets and money transfer operators.

The reasons go beyond socioeconomic and demographic characteristics such as age, education, ethnicity, and income. A recent report by the Chicago Fed and the Brookings Institution notes that immigrants are less likely to have checking and savings accounts compared with the native born, even after taking these factors into account. The length of time spent in the United States, language barriers, legal status, and experience with financial institutions in their home countries play important roles as well.

Lack of documentation is the most oft-cited reason why immigrants are discouraged from opening accounts. Many immigrants mistakenly believe that a Social Security Number, generally available to U.S. citizens and foreign nationals with work permits, is required. Undocumented immigrants are also concerned that banks will share their information with immigration officials, or that they wouldn't be able to access their funds if they are deported. This is a real fear among undocumented immigrants and a potentially high barrier to overcome, because it could mean the difference between staying and working in the United States (and sending money back home) and being forced to leave the country.

But current rules on opening an account at financial institutions do not require a Social Security Number for non-U.S. citizens. They require that banks set up a customer identification program that would, among other things, collect and verify information about customers opening an account. For non-U.S. citizens without a Social Security Number, the rules suggest immigrants can provide a similar identification number issued by their home government. For instance, many banks and credit unions accept as proof of identification Mexico's Matricula Consular, one of the few documents that illegal immigrants can obtain in the United States.

It is possible, however, that this may not be enough to assuage the fears of undocumented immigrants. Because the acceptance of foreign government-issued ID has become entangled in the debate over immigration policy, there may be concerns that the rules will suddenly change and turn against them. The rules at the moment, however, don't require banks to verify the immigration status of foreign account holders, and it is not even possible for banks to do that.

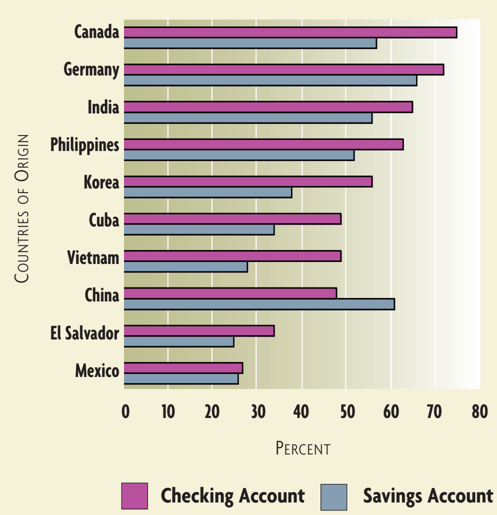
These fears may be related to many Hispanics' inherent distrust of banks, especially those who are new to the United States and do not hold the banking system in their countries in high regard. "There is a poor acceptance of financial institutions in Latin America," says Luis Pastor, CEO of the Latino Community Credit Union based in Durham, N.C. For instance, Pastor estimates that about 60 percent of Mexicans and 80 percent of Hondurans do not have bank accounts. If a poor person's parents and grandparents in Mexico never used banks, then he tends to be less inclined to use one.

There have been many incidents that have fueled Hispanics' distrust of banks. Mexico's banking crisis in the mid-1990s, for instance, "further damaged the reputational capital of Mexico's banking system and heightened suspicions that banks generally were unreliable," according to a World Bank paper. Manuel Rey, director of Banco de la Gente, a Charlotte-based bank catering to the Hispanic market, explains that the lack of deposit insurance was characteristic of banks in several Latin American countries many years ago. "If the bank would go bankrupt then they would lose everything they have deposited," says Rey.

Hispanics' reasons for preferring alternative financial institutions may also have to do with what they perceive as difficulties with a bank's products and services. With remittances, for instance, money transfer operators (MTOs) like Western Union and MoneyGram are still the carrier of choice. Although the cost of transferring money through MTOs is usually higher than through banks (especially if one has a bank account), costs are not the only factor in deciding how to send remittances. Remitters may prefer MTOs over banks because of their convenient locations, both on the sending and receiving ends. Large MTOs employ a vast network of distribution points, from banks to their own outlets to grocery stores to pharmacies. Many wire transfer services do not require identification for transactions less than $1,000.

Hispanic immigrants may also be unaware of the requirements for obtaining a loan and hence believe that they will be denied more sophisticated banking products like

Share of Immigrant Heads of Households with Bank Accounts



SOURCE: "Financial Access for Immigrants: Lessons from Diverse Perspectives," Federal Reserve Bank of Chicago and the Brookings Institution, May 2006

Reaching the unbanked: Audio series like these teach immigrants about life in the United States, including its banking system.

mortgages if they applied for them. Their fears may not be unfounded. Relatively few banks make loans based on a foreign national's Individual Taxpayer Identification Number (ITIN) — in this case, a Social Security Number is usually required — although that number is growing. Banks may be reluctant to lend to undocumented borrowers because ITIN mortgage loans will likely be difficult to sell in the secondary market.

But probably the most cited factor in many studies on the unbanked is that bank accounts can be expensive to maintain. The problem lies in having to carefully manage their bank balances. If they mistakenly overdraw their account, they can be charged expensive overdraft or bounced check fees. Because the unbanked often live from paycheck to paycheck, they may be more vulnerable to such charges. Overdraft fees and the stress of balancing one's account may outweigh the benefit of free check cashing and other payment services at the bank, so that it becomes a rational decision for the unbanked not to open an account.

Mind The Gap

Financial education is one of the first things that banks emphasize in bringing the unbanked into the financial mainstream. This may be especially true for areas with many recent Hispanic immigrants.

Although the largest concentration of Hispanics is in California and Texas, many are now moving into areas that previously saw very little immigration. The Pew Hispanic Center reports that the Hispanic population is growing faster in the Southern states, including the Carolinas, than anywhere else in the United States. North Carolina, for instance, is one of 13 states that have at least half a million Hispanic residents, and the community's population grew almost fourfold over the period 1990 to 2000.

Because Hispanics in the South are predominantly foreign born, these communities may have a greater need for financial literacy programs, cash remittance services, and bilingual tellers. Banks there "face the challenge of integrating this growing Hispanic population into the mainstream of the financial services industry," notes an FDIC report.

For the Latino Community Credit Union (LCCU), this task was particularly challenging since 75 percent of its members had never opened a bank account. The LCCU's financial education group, which is an entirely separate department from its marketing arm, gives classes in Spanish on various topics like how to manage a checking account, how to save and develop a budget, how to use a credit card, how to build a credit history, and how to buy a car and a home. These courses go beyond just giving information about the credit union's products. They also encourage participants to think about their families' goals and help them create a financial plan (including tips on how to pinch a few pennies) to take them there.

Complete with caps and gowns, members and nonmembers who graduate from these classes walk away armed not only with the tools to build their financial future but also with increased trust in the banking system. More than 9,000 participants have graduated from these classes since 2001. "Some invest in marketing. We invest in education. These are different topics," says Pastor.

BB&T's Bibi telenovelas, now on their ninth installment, aim for the same goal. Far from just promoting the bank's products and services, the episodes dwell on topics that can help Hispanic families ease their transition to life in a new country, such as what to do in the event of a storm (many of BB&T's branches are in the coastal areas), advice on how to find a job, and how a small family business can deal with a wayward debtor. In the end, the idea is that BB&T will be well served by nurturing a progressive Hispanic community within its footprint, with the hope that those there will become long-term clients. Jorge Moller, the bank's multicultural markets manager, expects that about half of their net new growth in the next five years will come from the Hispanic segment. To date, BB&T has given out about half a million tapes over the last four years.

Luring unbanked Hispanics by offering services that are essential to them like check cashing and remittances is another bank strategy. The hope is that by getting them in the door, banks will then be able to gradually move them up the financial ladder, from savings and checking accounts to more sophisticated financial products like education, housing, and small business loans.

It sometimes starts by getting people who use check cashing services to open bank accounts, which for some may take awhile. "The guys who work at the branch spend several visits until they develop their trust. [Customers] may come and cash their check six times before they give us a shot with an account," says Rey. But the patience pays off. "One of the things we found is that once they open an account, they can be very loyal. Once they know that the money is there and nobody is stealing the money and that the bank is still open, then they stay with you. They develop a relationship," says Rey.

Banks also bundle their payments and money transfer services with their checking accounts, allowing them to give attractive rates on products like remittances. Bank of America's SafeSend, for instance, provides free

PHOTOGRAPHY: COURTESY OF BB&T

money transfers to Mexico if customers open a checking account. Banks and credit unions can also participate in the Federal Reserve's Directo a México, a low-fee money transmission service launched in 2004, which requires the sender as well as the recipient in Mexico to open bank accounts.

The acceptance of consulate IDs and ITINs as identification has provided opportunities for many unbanked Hispanics not just to open savings or checking accounts but also to obtain loans. Even so, one other barrier to obtaining loans is the lack of a credit history, and banks do offer products with which customers can establish credit, such as a secured credit card and a CD secured loan. These products give customers a chance to demonstrate, over a certain period, their ability to take out a loan and pay it on time, which is then promptly reported to the credit bureau. Once their credit is established, they may be eligible for loans such as ITIN mortgages, which some banks are beginning to offer and are available to immigrants without a Social Security Number.

As Hispanics climb up the financial ladder, they may also be interested in taking out small business loans. "Hispanics are very entrepreneurial," says Jorge Figueredo, executive vice president of Security One Bank in Fairfax County, Va., which caters in part to small- and medium-sized Hispanic businesses in that area. In Fairfax County alone, there are about 7,302 Hispanic-owned businesses, according to the 2002 U.S. Census Survey. This represents almost 8 percent of all businesses in Fairfax County, and about 38 percent of all Hispanic-owned firms in Virginia.

In all, banks have made significant strides toward earning the trust and business of the Hispanic community.

Room for Improvement

The catch is that it is difficult to say exactly how successful efforts have been to move the unbanked into the banking system. "No one really has any actual figures on any of these issues, what they have is a gut feeling of how they're doing," says Manuel Orozco, executive director of the Remittances and Rural Development project at Inter-American Dialogue, a policy analysis group.

But Orozco thinks that some banks are still not doing enough. Despite all the hype about Hispanic banking, he senses a lack of interest and a lack of understanding of this market, especially among the bigger banks, which could lead to frustrated efforts to bring in unbanked Hispanics.

Perhaps what some banks are doing wrong is that they have relied too much on peddling the product without really understanding the root cause of why the unbanked choose to stay away. Earning their trust is one hurdle. But, as John Caskey, an economist at Swarthmore College, points out, the biggest problem for the unbanked is the stress of living without any financial savings, of being one hiccup away from another crisis. Bank accounts are costly for people who don't earn enough to put away in an account, as they require extremely careful management to avoid a multitude of fees.

In this sense, Caskey thinks that "focusing on the bank account itself is a little bit like focusing on the symptom rather than the underlying cause." If the unbanked could somehow be persuaded to set aside even a little bit each month, then having a bank account could not only lower the cost of their check cashing and other payments transactions, but also, more importantly, add some stability to their lives.

Seen this way, the challenge looks harder for banks than may have been thought, because how can you encourage unbanked Hispanics — many of whom live on low incomes — to consume less and save more? It may not be as easy as installing Mexican artwork, adding a few more chairs to accommodate other family members, or even hiring bilingual tellers.

Banks that provide the kind of financial education that motivates unbanked Hispanics to become homeowners and entrepreneurs, to save for retirement, and insure themselves against financial risks may be on the right path. But even those banks realize that big payoffs will take time. Banking the unbanked is a long-term investment. **RF**

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Midlife Medicare

The case for reform heats up

BY BETTY JOYCE NASH

Like the boomer birth cohort that threatens its existence, midlife Medicare needs an overhaul. But it will take more than a facelift and weight loss for the plan to function through the biggest challenge of its 42 years — seeing the post-World War II generation through old age.

Consider that one in every five West Virginians use Medicare, the biggest percentage of beneficiaries in the nation, a reflection of that state's aging population. Nationwide, the average is one in seven.

Medicare is the nation's public health pledge, placed into the Social Security program as the centerpiece of President Lyndon Johnson's Great Society along with its sister Medicaid, to ease medical expense for the elderly. (Medicaid pays for poor peoples' medical care and long-term care.)

At last count, some 37 million use Medicare, along with 6 million disabled people. About 7.5 million of those are "dual eligibles" — they use both Medicare and Medicaid.

The first of the boomers will arrive at Medicare's door in 2010, at a time when there will be 3.6 workers per beneficiary (compared with four today) forking out to keep the system going. By 2030, when the last boomer turns 65, only 2.3 workers will be paying in. Policymakers may have to consider major changes sooner rather than later.

Challenge and Opportunity

Medicare is plagued by some of the same inefficiencies that dog the health care system overall. Competitive markets can match prices to costs pretty well, but health care markets are imperfect, a result mainly of the third-party payment system, whether under government or private insurance. Health care markets have problems with information asymmetries (when one party in a transaction knows more than the other), moral hazard (when people use more of something than they otherwise would because they're not paying the bill), and adverse selection (when the price of insurance or care doesn't depend on how sick you are; the sickest, who are the most costly to treat, get a relatively better deal), among others.

Current projections indicate that by 2050, Medicare may balloon to account for 9 percent of the nation's total of goods and services, compared with 2.7 percent in 2005, according to the 2006 report of the Trustees of Social Security and Medicare trust funds. Funding problems have been discussed for decades, especially during recent debates over the Medicare Prescription Drug, Improvement, and Modernization Act (MMA), which passed in 2003.

Medicare's hospital fund (paid for through a 2.9 percent payroll tax shared equally by employers and employees) in 2005 spent $183 billion on income of $199 billion. By 2010 expenses will overtake income, exhausting trust fund reserves in 2018, according to trustees' projections. By then the fund won't generate enough to pay benefits. (That's two years earlier than the trustees reported in 2005.) Medicare's supplemental program, Part B, which pays for doctors, outpatient work, lab work, supplies, and home health, is funded through premiums (25 percent) deducted from Social Security payments, and general tax revenues (75 percent). Only continued hikes in premiums and general revenue contributions will sustain the fund under current design. Many Medicare beneficiaries also pay for "Medigap" coverage, private insurance that helps cover co-pays and services Medicare doesn't cover.

It's worth noting that nearly all elderly beneficiaries on Medicaid are also on Medicare, and about 40 percent of the disabled who are on Medicaid are also on Medicare. Together they make up a big share of the Medicare population, particularly among the sickest, according to Leighton Ku of the Center on Budget and Policy Priorities. States share the funding of Medicaid with the federal government, while Medicare is mostly a federal program.

The two programs are inextricably linked. For example, poor people use Medicaid to pay Medicare premiums. Because Medicaid sneezes when Medicare catches a cold, any fixes to Medicare need to be well thought out.

Now Hear This

By 2008, arguments over Medicare funding will intensify. That's because the MMA triggers a presidential warning when trustee forecasts say general revenues will finance 45 percent or more of total Medicare spending in any of the next seven fiscal years. Two warnings trigger legal obligation for the president to submit legislation to Congress.

OK, so here's the first warning, says the 2006 report. And according to trustee and economist Tom Saving, "Unless things are dramatically different, we'll do it again in 2007." If so, in January 2008, the president would submit a plan to Congress, forcing debate. (However, Congress doesn't have to act.)

Politically palatable solutions are scarce, owing to philosophical differences about the extent of government responsibility for health care. Some people consider keeping current benefits intact a moral obligation, others favor trimming benefits, and others want people in charge of their own medical accounts so they'll have an incentive to monitor spending. Mainstream economists, for the most part, think such "consumer-directed" care will introduce competition and efficiency. The MMA calls for trying out that savings account idea in 2007.

More Money, More Life

Medicare spending grows each year, but its average per-capita spending growth between 1969 and 2003 (9 percent) was less than for private insurance (10 percent), according to Centers for Medicaid and Medicare Services (CMS). (Joseph Antos, a health care economist who serves as a Commissioner of the Maryland Health Services Cost Review Commission, has disputed this estimate, pointing out that private firms expanded coverage over that span. In 1970 private insurance paid 60 percent of hospital and doctor services, but 85 percent in 1999.)

Overall, health care costs rose about 7 percent in 2005. Cutting-edge cures and life-prolonging drugs push up costs. Just as longer lives create payment problems for Social Security, ditto for health care. People can expect to live 18 years in retirement, much longer than expected when the plan was unveiled in 1965. Somebody will have to pay for those extra years of health care. For instance, implanting defibrillators for cardiac arrhythmia, if expanded to half of the elderly with new cases of heart attacks, would mean about 374,000 annual procedures in 2015 and cost $14 billion, adding up to $132,000 per additional year of life, according to the RAND Corporation's "Future Health and Medical Care Spending of the Elderly."

Reducing chronic illness among Medicare beneficiaries could save money, but only slightly. Overall, RAND's "Future Elderly Model" found that people will live better and live longer, but the innovations increase rather than decrease costs.

Obesity may be a different story. Researchers found that starting at age 70, an obese person will cost Medicare about $149,000 over a lifetime, the highest level of any group, 20 percent higher than for the next closest group, the overweight, and 35 percent higher than normal weight people. Medicare could spend $38,000 more over the lifetime of an obese 70-year old than a beneficiary of similar age and normal weight. If obesity is responsible for the health differences, then preventing or curing it would save Medicare money, according to the RAND report.

Competitive Edge

Politicians of every stripe, accompanied by health care policy experts, are searching for a way to get seniors through old age without dragging down the economy and discouraging young workers in the bargain.

Trimming costs and adding payers, such as through more and higher-paid immigrants, may help. And worker productivity is expected to increase, so the necessary tax rate need not rise appreciably if productivity increases slightly more than historical rates, according to health economist Mark Pauly of the University of Pennsylvania.

The source of Medicare's malady may lie in the third-party insurance payment system itself. If you don't pay for services out of your own wallet, then you tend not to pay attention to the bill. Was the proper service rendered, how much did it cost, and are those prices true? If you bought a television set over the holidays, you probably surfed the Internet and combed newspaper ads for the best price. But few people do that with medical costs — unless they're uninsured or self-insured — because few pay out of pocket for services. That leads to vast inefficiencies in health care even in the private sector.

"One of the biggest problems with Medicare and health care even is customers don't care what it costs. If the buyers don't care when they go in, the sellers aren't going to care," says economist Saving, who in addition to serving as a trustee on the Social Security and Medicare Trust Funds teaches at Texas A&M University. He points out a case of cheating in 2000 with some providers improperly coding conditions so they would be reimbursed at a higher level. After a policing effort, costs came in below forecasts. "The real problem is that the prices are all fiction," he says. In a true market, with winners and losers, accurate pricing emerges through competition, but Medicare sets prices administratively.

Inefficiencies abound in the entire health care system, not just in Medicare, and they include lack of accountability and care coordination, technology that may not be worth the cost, and little incentive for cost-effectiveness. Paying providers the same rate regardless of the quality of care doesn't do anybody any good. Moreover, "perverse payment system incentives, lack of information, and fragmented delivery systems are barriers to full accountability," according to a 2006 Medicare Payment Advisory Commission (MedPAC) report to Congress. Under Medicare's fee-for-service system, "doing more pays more, regardless of the quality or efficacy of what is done."

A wide range of proposals could "fix" Medicare, Saving suggests, but he warns that "anything will be a benefit reduction." Which might not be such a bad thing, he says. "If the benefit reduction is big enough, customers might start caring what things cost." Raising the eligibility age, which has been suggested, is unlikely to help because younger enrollees are responsible for a relatively small percentage of total Medicare expenditures. This is in contrast to Social Security. Raising the age at which people would begin receiving benefits from that program could help its potential fiscal imbalance. This is one of many reasons why some economists believe Medicare is a tougher problem to fix than Social Security.

Cost sharing shows promise. According to the 15-year RAND Health Insurance Experiment, hefty deductibles reduce spending through careful use of services. Saving says a $5,000 deductible would protect people from catastrophe while dramatically reducing the necessary transfers from general revenues. Plus, the money would stimulate competition. "In reality if you looked at 79 million retired people — $5,000 times 79 million — the providers would be competing for that money."

Other Medicare fixes range from enticing more private payers into the market for competition's sake, including incentives for disease prevention, benefit cutting, or means testing, among other policy combinations.

Means testing is coming. The MMA will vary premiums and benefits by income, setting higher premiums for well-off seniors. In a 2004 paper, economist Pauly proposed "a strategy in which future Medicare beneficiaries with higher incomes will pay for cost-increasing but quality-improving new technology, possibly with prefunding that begins before retirement."

Further regulation, especially clamping down on prices, may produce undesirable results. Reducing payments to providers is an idea economists don't like because economic theory suggests it can induce shortages, which has happened with Medicaid, says Robert Helms, director of health policy studies at the American Enterprise Institute. Or it can also cause a jump in service, as providers make up for lost revenue. Such changes would likely be more noticeable in regions with high percentages of Medicare enrollees, like West Virginia.

"[There are] lots of ways physicians can skimp on the service, and some are subtle," he notes. "Just cutting the rates is a short-term and misguided policy. You have to get to a situation where everyone has an incentive, patient and provider, to worry about cost and quality and cost-effectiveness."

In an effort to keep rural doctors from becoming scarcer than they already are, Medicare is paying them a bonus, part of the MMA of 2003. That's good news for rural states like West Virginia. In addition to its aging population, with more deaths than births, the state is overwhelmingly rural. Forty-five of its 55 counties are rural.

Clamping down on prices often backfires. In the 1990s, a supplemental Medicare + Choice plan was done in by "top down price setting and com-

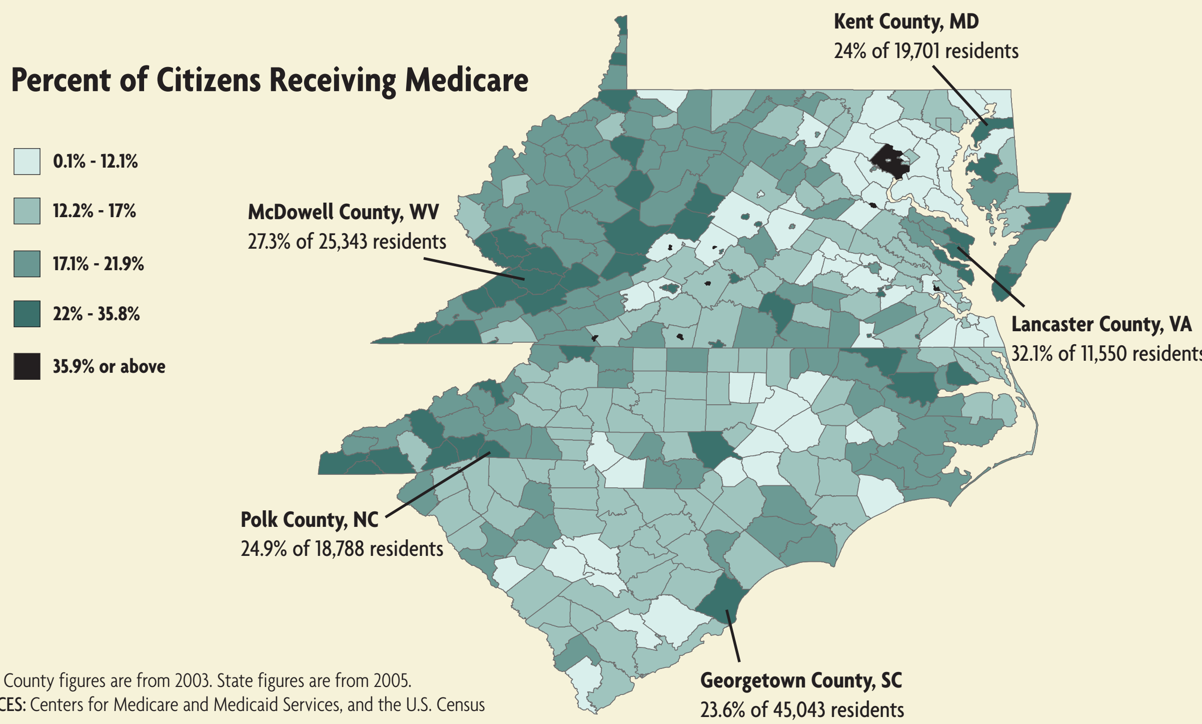
Rural Density

Fifth District counties with the biggest percentage of Medicare enrollees tend to be rural, a designation that varies according to federal agency and program.

Some 19 percent of West Virginians use Medicare, compared with 14 percent nationwide, reflecting the fact that 45 of the state's 55 counties are rural. A bulging pocket of elderly live in southern West Virginia's McDowell County, where the decline in coal mining has hurt the local economy. About 27 percent of the county's 25,343 people are Medicare beneficiaries.

Other Fifth District counties with high percentages of Medicare enrollees include growing retirement locales such as Polk County, N.C., near Asheville, and coastal Georgetown County, S.C., as well as the Chesapeake Bay area's Kent County, Md., and Lancaster County, Va.

Also noteworthy: North Carolina and South Carolina exceed the national average for Medicare enrollees who are disabled, with percentages of 19 and 20 respectively compared with 15 percent, the U.S. average. About 23 percent of West Virginia's Medicare enrollees are disabled.



NOTE: County figures are from 2003. State figures are from 2005.
SOURCES: Centers for Medicare and Medicaid Services, and the U.S. Census

plex regulation," health economist Antos writes. Providers can always get creative and expand services to counter price controls, according to Antos, who has written extensively about using markets to strengthen Medicare.

"Tighter controls that also restrict the use of services could prevent that, but such restrictions would have adverse consequences for the health of beneficiaries," he writes. In 2002, Medicare cut doctors' fees by 5.4 percent, which prompted service disruptions in some geographic areas and didn't save money. Payments increased by nearly $3 billion, thanks to extra service volume, a 7.9 percent increase in 2002 compared to a 3.5 percent increase in 2000 and 2001. "It would be difficult to argue that such a sharp increase in volume last year was justified solely on clinical grounds."

Medicare Woos Private Payers

Medicare Advantage, a transformation of the old Medicare + Choice plan, aims to reinvigorate private plan participation (through various financial incentives) and competition after many insurers left the program. Their defection was a response to restricted payment rate growth in high-cost areas. Private plans have been an option since 1982, with enrollment peaking at 17 percent of enrollees in 1999 and declining to 12 percent by 2004, according to MedPAC.

Medicare Advantage lets participants choose private plans in lieu of the traditional fee for service plan. Under some plans, participants may receive more benefits than Medicare offers, and they'll pay more in premiums. Medicare pays plans a capitated (per person) rate that amounted to $55 billion in 2005, or 17 percent of total Medicare spending, according to MedPAC. Plans bid and the bids are compared with county-level benchmarks to determine payment. If the plan bids above benchmark, then that's the payment and participants pay the difference. But if the bid is under benchmark, then the Medicare program keeps 25 percent of the difference, and 75 percent is rebated to the plan, which is obligated to return it to the enrollees in the form of lower cost sharing. Enrollment is now about 7 million of the 46 million beneficiaries.

Among plan advantages is the emphasis on coordination of care, says Teresa DeCaro, acting deputy director of the Medicare Advantage Group at CMS. Medicare's fee-for-service program has no incentive to manage care among providers, she notes. "In a capitated arrangement, the plan is only profitable if the costs incurred match or beat expected costs," she says. "They're always looking to arrange services and put cost-effective administrative structures in place so beneficiaries are receiving the best mix of services to keep them out of hospitals and nursing homes, the kinds of things that are really expensive to do. That's where all the dollars are."

In addition to reviving competitive alternatives, the MMA introduced Medical Savings Accounts in 2007. Medicare pays for a high-deductible plan for enrollees, establishing an account with the designated funds. The money and its earnings are tax free as long as it's used for health care. After meeting the deductible, the health plan covers the medical services. Unused amounts are rolled over even if the enrollee opts into a different plan. This provides an incentive for relatively healthy people to be discriminating when choosing care while the catastrophic limits protect very sick people from facing huge bills.

Antos has floated a Medicare reform that uses as a model the Federal Employees Health Benefits Program (which includes retirees as well as active employees). Beneficiaries would choose from competitive plans including a Medicare fee-for-service plan. A common objection to market-based Medicare reforms is that insurers will choose only healthy people, what's known as risk selection. Antos suggests more compensation for sicker enrollees to provide incentives (as well as oversight for corrective action if necessary). For example, the federal employee health program subsidizes enrollee premiums. Because of the high subsidy, a recent study found small differences in the average age of enrollees in low- and high-cost plans. Currently, consumer-driven plans, typically low-premium but high-deductible plans, account for about 3 percent of the private health insurance market.

Competition will improve efficiency, the theory goes. But a careful, cost-conscious health care consumer is the critical link to competition. And with new choice in Medicare plans and Medical Savings Accounts, that's the aim, according to DeCaro.

"The presumption is that beneficiaries are more engaged, more aware of the costs of health care," she says. "Therefore they're more inquisitive and more interested in good information about health care choices."

Informed health care consumers? Efficient health care markets? No matter what, soon we will likely see the end of Medicare as we know it. Come 2008, some of these proposals could become policy. **RF**

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Bad Luck or Bad Policy?

Why inflation rose and fell, and what this means for monetary policy

BY VANESSA SUMO

Wars have often fueled inflation. Throughout history, printing money was a handy way for governments and empires to fund war-related expenses without raising taxes. However, with too much money chasing too few goods, price levels would then shoot up. In 1970s America, though, wars were not the stuff that fueled inflation. Indeed, economist Brad DeLong of the University of California at Berkeley calls the Great Inflation of the 1970s, "America's only peacetime outburst of inflation."

No matter which measure is used, inflation was high and volatile in the late 1960s to the early 1980s. There were three different inflation cycles during this period, and each peak of the cycle was higher than the last. By the first quarter of 1980, inflation had risen more than 14 percent over the previous year. However, after hitting that high point, inflation rapidly declined and has remained remarkably low and stable over the last two decades. How can we explain this unmistakable shift?

It is tempting to assign blame or praise to the members of the Federal Reserve's Open Market Committee, who were at the helm of the central bank during these various episodes. Much credit, for instance, has been given to Paul Volcker and Alan Greenspan for driving down inflation during their tenure. But couldn't they have also been lucky? Similarly, weren't Arthur Burns and G. William Miller just hit by a string of bad luck? After all, the twin oil shocks of the 1970s must have had a devastating effect on the economy.

Whether the rise and fall of inflation is thanks to luck or policy is an important question because the answer tells us to what extent monetary policy matters for economic stability or if we are simply helpless to the vagaries of the business cycle. "Do we think that we've learned some lessons from the 1960s and 1970s, so that [the Fed] should keep doing what they've been doing? Or do we think that we just got lucky? If so, that doesn't tell us much about future Federal Reserve policy," says Mark Watson, an economist at Princeton University and a visiting scholar at the Richmond Fed. The answer is far from settled, but it could be a good measure of both.

Policy Mistakes and Triumphs

The story that policy rather than luck is responsible for the rise and fall of inflation is, according to Chicago Fed economist Francois Velde, "an optimistic story that relies on errors made and lessons well learned." Learning from policy mistakes of the past is a crucial point for this view because it provides a reason why policymakers engineered a decisive break in their response to inflation in the early 1980s.

The story begins with the memory of the Great Depression of the 1930s. DeLong believes that "the truest cause" of the 1970s inflation was the shadow cast decades later by this extraordinary economic downturn. The Great Depression may have led to the Great Inflation because that event cultivated a strong aversion to unemployment, convincing policymakers that any level of unemployment was too high.

At the same time, work by some of the best economists of the 1960s reassured policymakers that lower unemployment could be successfully purchased by allowing only moderate increases in inflation. For instance, estimates by Nobel Prize winners Robert Solow and Paul Samuelson of the trade-off between inflation and unemployment for the United States (the Phillips Curve) suggested that a modest 4.5 percent increase in prices each year would be enough to bring down the unemployment rate from 5.5 percent to 3 percent.

Against this backdrop, the Fed, under William McChesney Martin Jr., proceeded with what it thought would be a successful experiment of stimulating the economy through expansionary monetary policy without accelerating inflation. But as Velde notes, unemployment indeed fell by 1969 — but to only about 4 percent and at a high price tag of 6 percent inflation, not exactly the terms that it had bargained for.

By the time the 1970s rolled in and Burns was appointed as the new head of the Fed, inflation had started to escalate to worrying levels. At this point, it was becoming clear that the trade-off promised by the Phillips

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Curve could no longer be fulfilled. Once people came to anticipate more inflation, any surprise expansionary attempts by the Fed would only result in higher inflation but without a substantial decrease in unemployment below its "natural rate." However, neither Burns nor the political leadership at that time were willing to lower inflation for fear of the extremely high cost it would entail in terms of the loss of jobs.

The triumphant moment arrived when Paul Volcker took control of the Federal Reserve at the end of the decade, armed not only with the political mandate to purge inflation but also with a bagful of hard lessons from policy mistakes committed in the recent past. An important lesson learned was that people form their expectations about inflation based on how they anticipate policymakers will react to it. In fact, policymakers themselves could alter the terms of the trade-off between inflation and unemployment. For instance, because people are well aware of policymakers' temptation to stimulate the economy with surprise inflation, central bankers must find a credible way to resist this temptation in order to effectively carry out monetary policy.

But how can we assert that the rise and fall in inflation was indeed due to a shift from bad to good policies, as sketched in the story above? Two studies, one by Richard Clarida of Columbia University, Jordi Gali of Pompeu Fabra University in Barcelona, and Mark Gertler of New York University, and another one written more recently by Richmond Fed economist Thomas Lubik and Frank Schorfheide of the University of Pennsylvania, look for evidence that policy has changed over the relevant period in a way that explains the dramatic movement in inflation.

Both papers look at the responsiveness of the Fed's interest rate policy to changes in inflation during the pre-Volcker period on the one hand and the Volcker and Greenspan period on the other. The idea is as follows. Central bank behavior is captured well by a policy rule by which the Fed sets the federal funds rate, its monetary policy instrument, in response to deviations of current or expected inflation and output from some desired level. If the Fed wishes to successfully bring down inflation, a helpful measure would be to raise the fed funds rate by more than the increase in inflation, such that the real short-term rate rises and real spending falls. But if the fed funds rate changes by only a fraction of the change in anticipated inflation, then the Fed will effectively stimulate the economy through lower real short-term rates, which leads to further rises in inflation.

Such a policy that accommodates inflation, or a passive interest rate policy, is particularly bad because it not only prevents the Fed from stabilizing inflation, but it also can actually turn monetary policy into a source of economic instability. This can happen because passive policy leaves open the possibility that the economy be subjected to "sunspot" shocks, which are unrelated to economic fundamentals but matter anyway because people think they do.

For instance, sunspot fluctuations can occur when individuals correctly anticipate that the Fed will react too feebly to an inflationary shock. This anticipation is then built into future inflation, to which real interest rates decline, and the initial expectations are validated. Because of this, inflation can wander off the path it would otherwise follow. The same fate holds for fundamental shocks, such as productivity shocks, that hit the economy. Under a passive policy regime these can affect the economy in unpredictable ways. Thus, if a good or active policy is not in place, monetary policy itself could potentially lead to the type of volatile macroeconomic outcomes that we witnessed back in the 1970s. The work of Clarida, Gali, and Gertler, as well as that of Lubik and Schorfheide largely confirm this story.

Clarida, Gali, and Gertler were probably the first to "add precision to the conventional wisdom" that monetary policy was relatively well managed during the time of Volcker and Greenspan but much less so 15 years prior to Volcker. They confirm their suspicions that monetary policy was passive during the pre-Volcker period, whereas they find that during the Volcker and Greenspan era, the nominal interest rate was almost three times more sensitive to changes in expected inflation. "[Not] until Volcker took office did controlling inflation become the organizing focus of monetary policy," wrote Clarida, Gali, and Gertler. Hence, good policy had saved the day.

Lubik and Schorfheide revisit the findings of Clarida, Gali, and Gertler, and add even more precision to the latter's work by devising a more sophisticated method to estimate the dynamics of the economy. Their estimation results likewise allow them to ascertain whether there was a shift from bad to good policy by looking at the responsiveness of the nominal interest rate to inflation during the pre-Volcker and post-1982 periods. Like Clarida, Gali, and Gertler, they find that after the Volcker policy shift, monetary policy was much more aggressive in fighting inflation than in the 1970s. In addition, their method allows them to be more precise about the role of sunspot shocks and fundamental shocks during the period of passive policy, which had opened the door to erratic and undesirable paths of inflation and output in the 1970s.

These papers have prompted many responses, particularly to explain why rational policymakers would choose to follow the inferior policy that they did in the 1960s and 1970s. In the response offered by Giorgio Primiceri of Northwestern University, rational policymakers form their rules based on what they believe is optimal at that time, given the information they observe and what they know about how the economy works. In other words, policymakers were simply doing the best they could. "Alan Greenspan in the 1960s would have behaved very similarly to the chairman

In the 1970s, the U.S. economy experienced significant shocks, such as sharp rises in energy prices in 1973 and 1979. At the same time, the Federal Reserve pursued monetary policies that many considered unwise. Economists debate whether the high and erratic inflation of the period could have been contained if the Fed had acted differently or if the shocks to the economy were too much to overcome.

PHOTOGRAPHY: LIBRARY OF CONGRESS/LC-DIG-PPMSCA-03433 AND PHOTOSPIN

[then], just because Alan Greenspan in the 1960s would not have known what he knows now," says Primiceri.

One reason why episodes of high inflation can occur is if policymakers believe that the natural rate of unemployment is lower than it actually is. Their policies would then tend to be too expansionary, thus leading to higher inflation. However, this is not enough to explain why rational policymakers would let inflation remain high for such a long time. According to Primiceri, policymakers in the 1960s were under the spell of overoptimism, a condition that was encouraged by looking at the turbulent inflation data from the 1950s, which offered the false hope that inflation was quickly "mean reverting." Because they observed that inflation was moving up and down, they were convinced that if inflation went up, it would not be long before it would come back down again.

But what prolonged the rise in inflation was when this overoptimism turned into overpessimism in the 1970s. Policymakers thought that the sacrifice ratio, or the cost of bringing down inflation in terms of unemployment, was going to be very high. For example, in a 1978 article, Arthur Okun computed the sacrifice ratio based on the estimated trade-off between inflation and unemployment in the literature at that time to be at 10 to one. That is, in order to bring inflation down by 1 percent, GDP must contract by 10 percent, a very painful proposition. Things started to change only in the beginning of the 1980s, when the cost of inflation was finally deemed by all quarters as simply too high.

As Luck Would Have It

Not everyone believes in the optimistic story of bad policy turned good. For instance, the oil price shocks of 1973 and 1979 are considered one of the prime suspects in the terrible inflation of the 1970s. In that case, it may have been bad luck rather than bad policy that was driving the surge and persistence in inflation. But economists have at least three problems with this argument. First, inflation was already building up prior to each burst in oil prices, not the other way around. Second, it is not clear that these shocks affected wages, something that would have left a lasting impact on the course of inflation. Third, an oil price shock alone may not be enough to set off a sustained rise in inflation without the help of an expansionary monetary policy.

Still, fewer and more manageable shocks during the 1980s and beyond have made this period a relatively peaceful one. The decline in the volatility of output growth, due to this dose of good fortune, may have moderated inflation since the 1980s and made a central banker's job of taming inflation much easier. Such lucky shocks can come in the form of smaller ones like the absence of oil supply disruptions and the productivity resurgence of the 1990s, or more permanent changes in the structure of the economy. These include new ways to manage inventory that have allowed firms to smooth production, as well as improvements in banking and finance that have made it easier for consumers and businesses to hedge risks and soften their liquidity constraints.

But instead of trying to pick out what exact piece of bad or good luck there is to blame or be thankful for, more recent work has focused on analyzing how the volatility of such shocks has changed over time. If the rise and fall in inflation is indeed due to a change in the economy's fortunes, and not because of a policy shift, then the volatility of these shocks should have diminished in the 1980s and beyond.

Indeed, Princeton University economist Christopher Sims and Tao Zha of the Atlanta Fed find that, unlike the conclusions of the policy camp, the Fed's monetary policy rule did not change over time. Instead, what best characterizes the rise and fall of inflation in their view is "stable monetary policy reactions to a changing array of major disturbances." In other words, the differences in the two regimes can be traced to the change in the volatility of the shocks affecting these two periods. Sims and Zha point to the oil price shocks and the financing of the Vietnam War in the 1960s and 1970 as the source of this macroeconomic turmoil, and that shocks on such a scale have not recurred since.

On the surface, it is difficult to square how different economists can come to strikingly different conclusions – one says that a change in policy is responsible for the dramatic turn in inflation and the other says it is all about luck. The divergence lies in the methods that they use to get their results. For instance, Primiceri has two papers that argue in favor of each corner of the ring (although he says that his "policy" explanation is his favorite one). In his "luck" study, he uses a statistical model that imposes minimal assumptions and very little structure, and so allows the data in its most undisturbed form to weave its own conclusion. He and others like Sims and Zha who have used this approach tend to find results in favor of the luck side. On the other hand, those who take on more economic assumptions in their model, for instance, on how policymakers behave and make decisions, will tend to lean toward the policy side.

Similarly, Lubik's response to Sims and Zha's conclusions is that finding a change in the volatility of the underlying shocks to the economy can actually correspond to more than one economic structure or to more than one view of how shocks are transmitted throughout the economy. Thus, we cannot be certain that the bad luck-good luck story is the right explanation of what is observed in the data.

A Table for Two

Lubik and Schorfheide are able to measure the importance of sunspot shocks and fundamental shocks as well as to observe how exactly these disturbances could have led to the economic turmoil under a passive policy regime in the 1970s. They find that although sunspot fluctuations can explain a sizeable amount (about one-third) of the volatility in inflation, they do not do a good job of explaining the volatility in output growth. "It leaves the door open for an alternative explanation," says Lubik, "that [output growth volatility] may have been due to bad luck."

Thus, luck may play a bigger role in the dynamics of output growth. But if the behavior of output somehow affects inflation, then a bit of luck, not just policy, will also find its way to explaining the changes in prices. In the 1980s and 1990s, monetary policy was more aggressive, but at the same time, real shocks such as the adoption of information technology had a favorable impact on output growth and inflation. Thus, the fall in inflation in the last two decades could be explained by a combination of a lot of good policy and a bit of good luck caused by stable output growth. "I would put 70 percent on good policy and 30 percent on good luck," says Lubik.

Similarly, James Stock of Harvard University and Mark Watson of Princeton University find that monetary policy has played an important role in determining the path of inflation, but doubt whether it was instrumental for bringing about that happy period of stable output in the last two decades. "My view is that the Fed gets to take full credit for taming inflation; whether it gets credit for taming the business cycle is another question," says Watson.

In theory, the causation can run the other way. Monetary policy can ease output growth volatility as it works on inflation. But if at the same time the shocks to the economy have become smaller or if firms have become better at smoothing shocks, then these spells of good luck could be mostly responsible for the stability in output growth. Stock and Watson think that this is the story of the 1980s and beyond and hence conclude that monetary policy played, at best, a modest role in this period of moderation in output growth volatility.

Thus, there could be a role for both luck and policy, with policy getting the edge for inflation and luck for output growth. However, most are in agreement that the Fed should take much recognition for restoring price stability — and responsibility for maintaining it. **RF**

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INTERVIEW

Robert Fogel

In the early 1960s, few economic historians engaged in rigorous quantitative work. Robert Fogel and the "Cliometric Revolution" he led changed that. Fogel began to use large and often unique datasets to test some long-held conclusions — work that produced some surprising and controversial results. For instance, it was long believed that the railroads had fundamentally changed the American economy. Fogel asked what the economy would have looked like in their absence and argued that, while important, the effect of rail service had been greatly overstated.

Fogel then turned to one of the biggest issues in all of American history — antebellum slavery. In 1974, he and Stanley Engerman published *Time on the Cross*. They argued that on the eve of the Civil War, slavery was far from a dying institution. Compared to Northern agriculture, slave-based agriculture was relatively efficient. Moreover, slave labor was being put to productive uses in the manufacturing sector. Fogel and Engerman were certainly not justifying the South's "peculiar institution" — they were simply trying to understand and explain how that system functioned economically. Nevertheless, the book drew considerable criticism. Many of its conclusions, however, have stood the test of time and it has become a classic work in economic history. More recently, Fogel has turned to questions of economic demography, including why life spans have increased so significantly in the developed world.

Fogel started his teaching career at Johns Hopkins University, where he received his Ph.D. in 1963. He subsequently taught at the University of Rochester, the University of Chicago, and Harvard University, before returning to the Chicago faculty in 1981. Fogel was awarded the Nobel Prize along with another economic historian, Douglass North, in 1993. Aaron Steelman interviewed Fogel at his office in Chicago on November 13, 2006.

RF: I understand that your initial academic interests were in the physical sciences. How did you become interested in economics, especially economic history?

Fogel: I became interested in the physical sciences while attending Stuyvesant High School, which was exceptional in that area. I learned a lot of physics, a lot of chemistry. I had excellent courses in calculus. So that opened the world of science to me. I was most interested in physical chemistry and thought I would major in that in college, but my father said that it wasn't very practical and persuaded me to go into electrical engineering. I found a lot of those classes boring because they covered material I already had in high school, so it wasn't very interesting and my attention started to drift elsewhere. In 1945 and 1946, there was a lot of talk about whether we were re-entering the Great Depression and the widely held view was that we could not have full employment in a capitalist society. So those debates started to shift my interests to the social sciences and economics in particular.

RF: The 20th century has been a period of remarkable progress. Yet, as you have written, in the era immediately following World War II, many economists did not expect the American economy to do as well as it has. Similarly, economists generally believed that the future for many developing countries was going to be significantly bleaker than it turned out — that population growth was going to be a major problem and that it was quite unlikely that we would see such rapid progress among the "Asian Tigers," for instance. What do you think accounts for those overly pessimistic forecasts?

Fogel: A lot of it was the difficulty of escaping from the impact of the Great Depression and the influence of Keynesianism, one reading of which seemed to suggest that whatever had propelled capitalist economies during the 19th century and early part of the 20th century — major technical advances, the settlement of the frontier — had run out of steam. This view was common at Harvard, Princeton, and most of the other Ivy League schools. But it was hotly contested by people such as Arthur Burns and Wesley Mitchell who were centered around the National Bureau of Economic Research and Columbia. So it never firmly took hold there or at Chicago.

But, in general, the profession had become pretty pessimistic about the future and feared that depressions would occur with some frequency. Simon Kuznets, for instance, was the least ideological economist I have ever known, but even he was very cautious about the economy's future late into the 1940s. By then, he began to believe that we had entered a new era of economic growth and maybe the Great Depression was the exception, not the norm.

When I was beginning my graduate work at Columbia in 1956-1957, James Angell, who taught the monetary course and the basic macro graduate course, said that you still couldn't rule out the possibility that the economy was being kept afloat by wars. First, you had World War II and then you had the Korean War. So that uncertainty was still prevalent in the mid- to late-1950s, but I think it was beginning to shift as we started to see more technological change and export-led growth.

PHOTOGRAPHY: ANDREW CAMPBELL

RF: How has the practice of *doing* economic history changed over the course of your career? For instance, how have improvements in the processing of huge datasets affected the research programs of economic historians?

Fogel: Prior to the mid-1950s, there were no high-speed computers and even the best in those days were not as good as my current laptop. When they said "create a loop," they were not talking metaphorically. They gave you a peg board and you literally wired a loop.

If you were interested in doing empirical research, especially from micro data, the work was incredibly time-intensive. First, data retrieval was very hard. We used to have to go into archives with paper and pencil and record information by hand. Second, once you had assembled the data, it took a long time to write and run the computer programs and to input the data by punch cards. So, as the technology improved, you no longer needed to place such a high burden on theory. You could take several competing theories, test them relatively quickly, and find out which one was the most promising. Over time, this led us to increase our ambitions. In the work I did on the aging of the Union Army recruits, we could do careful longitudinal studies with a lot of medical information from the military wartime records and, for those who survived the war, from the pension records. That would have been impossible just a couple of decades before.

RF: You were one of the pioneers in using rigorous quantitative methods to examine questions in economic history. How was this approach received initially?

Fogel: Our teachers were very encouraging. They felt that what we were doing was new and important. Often, they did not have the same focus, but they thought that our techniques were appropriate. And those, like Kuznets, who were very empirically oriented, were, of course, supportive of the work. We did run into problems with some of the younger people, though. I remember going to one meeting of the British Economic History Society. Some young economic historians there said, "If you succeed, we will be unemployed." So they felt we were a threat, but they were wrong because the "old-fashioned" analytical history is always relevant. We did not want to replace that. We were providing an additional dimension. Happily, I think that strife has largely ended. The people who were at war with quantifiers will now say, "If quantification will help, by all means, count." They no longer think we are barbarians.

To do economic history well, you need to understand the social context in which people were acting, and a lot of that is qualitative, not quantitative. You have to understand from where the data have come — and whether the data are real. That's old-fashioned history.

I will give you an example. Bill Parker, who was an economic historian at Yale and one of the earlier cliometricians, was interested in the annual growth of cotton farming in the 19th century. He found a pamphlet produced by the Department of Agriculture that gave data for cotton production by county between census years. So he went to see the head of the department's statistical division, showed him the pamphlet, and asked if he had the raw data that were used to put it together. The fellow said he did not have the data but the man who wrote the pamphlet was still alive, occasionally came into the office, and the next time he did he would call Bill, who was working in Washington that year. So Bill eventually spoke to him and asked him how he collected the data. He said: "Well, I had the 1870 and 1880 census data. I had a big map of all the counties with information on elevation and other soil properties. I looked at the map and I looked at the census and I put those balloons where I thought they ought to be."

So that happens. Some of the data are manufactured. Just because something is in print doesn't mean it can be trusted. You have to go back and find out how those data were generated.

Also, there are all kinds of mistakes that are made in the census. When we go back to the original manuscripts, we find errors, with a column being shifted over a slot, or simple arithmetical problems, which means the numbers are not internally consistent. Those data might be useful for setting upper or lower bounds. Or, in certain cases, the effect of a bad number on your overall result will be so small that you can use it. But you have to be very careful.

RF: It seems that the United States has reached a point in its development that would have been remarkable to people just 50 years ago. For instance, food is so plentiful and cheap that we seem to be more concerned about obesity than malnutrition among those in the lower part of the income distribution. How large, in your opinion, are the changes that we see in the way people live today and what significance does that have for the way we should look at the process of economic growth?

What we currently call the poverty line is so high that only the top 6 percent or 7 percent of the people who were alive in 1900 would be above it.

Fogel: First of all, we are much richer than we used to be. What we currently call the poverty line is so high that only the top 6 percent or 7 percent of the people who were alive in 1900 would be above it. That, by the way, is also true when you compare us to other developed countries.

England is a rich country but we are 50 percent richer, and we do things that seem wasteful to the English. My wife came down with pneumonia in 2001 in London. She was treated at one of the city's top hospitals, Guy's and St. Thomas' Hospital, which is directly across from Parliament. Everything there was in wards, whereas in the United States rooms are typically private or semi-private. Americans today are used to having a phone beside their bed and 40 channels of television to watch while they are recuperating from an illness. That is unusual, even in other rich countries. Also, the way the diagnosis of her ailment was conducted was different from the typical procedure used in the United States. The doctors and nurses were very good but they never X-rayed her. They just listened to her lungs and came to the conclusion that she had pneumonia. If she had been in the United States, the doctors typically would have X-rayed her as a precautionary measure. So we make all sorts of investments that the British are not willing to make. They spend $1,193 per person per year on health care, while we spend $3,724.

We can do that because food, clothing, and shelter, which used to be 80 percent of a family's expenditures, now account for only 35 percent. And a large part of the food expenditures actually go toward services rather than on consuming nutrients — for instance, when you eat at a restaurant or when you buy food at a supermarket that is highly processed. So we have become much richer over time and also compared to the rest of the world.

I think there is a synergy between technological improvements and physiological improvements. As you suggested in the question, we are not the same people that we were in the past. The life expectancy 350 years ago was about 30 years at birth while it's about 78 years now in the United States and England. We're taller than we were by about 10 inches and the median weight is about 50 percent greater. Our immune systems function much better and our endocrine systems work better. Also, if you have a health problem, we have interventions that are very effective. So, the advances in public health and in medical technology have allowed us to improve the quality of life. Of course, health care is more expensive too. But that's a trade-off that a rich country can afford to make.

RF: Per-capita income grew very rapidly during the 19th century, yet life expectancy did not seem to be greatly affected until the 20th century. How would you explain that? Is it simply, or at least mostly, a matter of significant innovations, especially in the pharmaceutical and medical industries, during the 20th century?

Fogel: Part of it is that technological advances tend to build on each other. For instance, we did not get really good control over the techniques for purifying drinking water until about World War I, but we needed everything that was done up to that point to figure out how to do it. Then there was a diffusion process. Some cities implemented systems quickly but others didn't because it was very costly. There is a very interesting article by David Cutler and Grant Miller looking at the arguments in different cities for and against spending money on water-purification projects. It often took cities many years to finally go ahead and fund those projects.

We have looked at the relative importance of such large-scale public health programs and it appears that they did a great deal to expand life expectancy. Then there are issues regarding the preparation and distribution of food products. In 1900, about a third of cows in the United States had bovine tuberculosis. Even when dairies started to pasteurize the milk, it wasn't very effective. There were a lot of contaminants that made it into the milk. So we probably didn't get a safe milk supply until the 1930s. Poultry is another example. Kids now think that chicken is something that is manufactured in some plant. They don't realize that it was once a living animal. When I went shopping with my mother and you wanted a chicken, the butcher would go in the back room and bring out a live chicken. My mother would feel its breast and say, "No, I don't want that one. Bring me another one." When she would finally choose one, the butcher would break its neck, chop its head off, and bring it back to us plucked and singed. That process introduced possibilities for contamination. Now, the purity of the food supply is very good — so good that when a problem slips through, it makes national headlines.

The people who have benefited the most from these innovations have been the poor. Those at the top of the income distribution were always eating the best food available. They also were living in houses that were separated from the rest so they didn't have to worry about their wells being contaminated by seepage from the neighboring buildings. So the major beneficiaries of these public-works projects and technological changes have been the poor, who now have access to safe food and water, which is relatively cheap. But the wealthy also have benefited since the odds of cross-contamination are now low.

RF: Could you please describe what you mean when you use the term the "Fourth Great Awakening"? And how does this concept differ from, say, Ronald Inglehart's idea of "post-materialism"?

Fogel: Inglehart is one of many writers who have dealt with post-consumerism. The basic idea is that once a society reaches a certain level of material wealth, people really take many material things for granted and begin to search for other things — nonmaterial things — to enrich their lives. The example I like the most is that in 1870, the head of the household used to have to work about 2,000 hours to provide the annual food supply for the family. Now, that person has to work only about 240 hours. And with the price of food still declining, that figure will soon be closer to 160 hours.

Here is another example: We now take electricity for granted, but to make electricity widely available, you have to build up a huge physical structure that produces and distributes it. I'm old enough to remember when not all parts of New York had electricity. They had metered gas as the form of lighting. You would put a quarter into the meter and get 24 hours of gas or something like that. In fact, when I was an undergraduate, I read that about two-thirds of the houses in the 1930s did not have electricity. I didn't realize how new electricity was, and we did not finish providing electricity to the rural areas until the 1960s.

Well, my kids don't remember a time when you did not have televisions. In fact, TV sets were so cheap when they were growing up that you could afford to have one for each person rather than having to fight over who was getting to watch their favorite program on the lone set. What is available to the mass public is so much greater than what was available not so long ago. Going to the opera used to be considered an elite activity. What is new is that even a person with modest income can rent a DVD of an opera. So people's discretionary time has increased dramatically and they are able to pursue interests that they could have only dreamed of in the past. That, I think, marks a whole new age for many Americans.

RF: Culture was a subject that interested many of the classical economists but fell out of favor for a while and now has experienced somewhat of a rebirth. In your opinion, how important of a role does culture play in a country's economic development? And from a purely methodological standpoint, how do you measure that?

Fogel: It's true that the impact of culture is difficult to measure. But if you assembled a group of economic historians and development economists in a room, I think there would be nearly unanimous agreement that there are some cultures that are pro-growth and some that are anti-growth. I'm writing an article for *Daedalus* in which I forecast global growth rates, with a special emphasis on the European Union (the original 15 members), the United States, China, India, and about half a dozen Southeast Asian countries. In it, I argue that China's per-capita income will grow about 8 percent per year until about 2040, while India's will grow about 6 percent, even though India's growth rate is currently higher than that.

The reasons I give are largely cultural. There are too many people in India — some call them "rural romantics" — who would be willing to pay a price of two or three points in the growth rate in order to preserve certain traditional values. Also, there are more ethnic minorities in India than there are in China. Over 90 percent of China's population is Han Chinese and although the central government worries about the Western provinces, which are mostly Muslim, that problem is more economic than political. In fact, China is subsidizing those provinces in order to reduce the gap between them and the coastal areas.

Robert Fogel

➤ Present Position

Charles R. Walgreen Distinguished Service Professor of American Institutions, Graduate School of Business, University of Chicago

➤ Previous Faculty Appointments

Johns Hopkins University (1958-1959), University of Rochester (1960-1964 and 1968-1975), University of Chicago (1964-1975), and Harvard University (1975-1981)

➤ Education

B.A., Cornell University (1948); A.M., Columbia University (1960); Ph.D., Johns Hopkins University (1963)

➤ Selected Publications

Author or co-author of several books, including *Railroads and American Economic Growth: Essays in Econometric History* (1964); *Time on the Cross: The Economics of American Negro Slavery* (1974); *Without Consent or Contract: The Rise and Fall of American Slavery* (1989); *The Fourth Great Awakening and the Future of Egalitarianism* (2000); and *The Escape from Hunger and Premature Death, 1700-2100: Europe, America, and the Third World* (2004)

➤ Awards and Offices

Co-winner of the Nobel Prize in Economic Sciences (1993); Fellow, American Academy of Arts and Sciences; Member, National Academy of Sciences; Past President of the American Economic Association and the Economic History Association

I think that there are too many cultural issues in India for them to be quite as focused as China in pursuing high-growth policies.

This is analogous in a sense to the European countries: They are willing to make similar sacrifices in their growth rates in order to preserve what they see as important cultural values, such as equality. There are similar forces at work in the United States. For instance, I believe that the Green Party, if it ever achieved much political success, might sacrifice economic growth in order to achieve other ends. It is possible for rich countries to achieve both — to get rapid economic growth while enacting reforms to ameliorate the social problems they see as so important.

RF: You have made contributions to a very large number of topics in economic history, but it seems clear that your work on slavery in the antebellum United States — especially *Time on the Cross* — has garnered the most attention. How did you become interested in the topic and how, if at all, have your views changed since that book was published?

Fogel: First of all, we did not initially believe what we were finding. The debate over the economics of slavery was an old one. It went well back into the 19th century. But the view that dominated was the Republican view of slavery, which was a political view, not an economic one. It included the proposition that slavery was so bad economically that it even made the slave owners worse off. That view appears in the work of Frederick Law Olmsted, when he said that a slave owner with 50 slaves was poorer than the average policeman in New York City. When you think of each slave as having the value of a Rolls-Royce in today's dollars, imagine how far off Olmsted's argument seems to be. It was only ideology that could produce this type of argument.

The abolitionists, especially the fundamentalists, knew that slavery was wrong, that it was a sin. So that's all there was to it — there was no discussion beyond how to get rid of it. William Lloyd Garrison believed in immediate emancipation gradually carried out. Salmon Chase — who was the governor of Ohio, Secretary of the Treasury, and later a Supreme Court justice — was the most brilliant abolitionist politician. Chase's reaction to Garrison was that Garrison wanted to wear sackcloth and eat burnt ashes, while Chase wanted to build coalitions broad enough to bring the system down, even though that involved compromising some principles. So the abolitionists were similar to the Religious Right. They believed they were in direct contact with God. Many of the famous abolitionists at one point or another walked into the woods and had a spiritual encounter. They were not people who could be said to be big believers in the Chicago School of economics.

So when the cliometricans started out, it was widely believed that a system as evil as slavery could not be economically efficient. But there had been some economists who had measured the profitability of slavery and found that it was a profitable enterprise. Slave owners made at least the market rate of return. But few doubted that it was less efficient than free labor in the North; there really wasn't another side to the argument. When we first performed a back of the envelope calculation, it turned out that slave farms were 6 percent more efficient than free farms.

Stan Engerman and I found that result silly so we decided to do a more careful study. We thought that we would then find that slavery was something like 90 percent as efficient as Northern labor. That was a smaller gap than we originally thought it would be, but it still was the less efficient of the two systems. However, the more refined calculations produced a different result. It showed that slave agriculture was 36 percent more efficient than free agriculture. So we had a problem at that point — our results did not conform to what we had predicted or what theory might suggest — so we did what economists do when faced with such a dilemma: We applied to the National Science Foundation and got a grant to study the issue in more depth.

W. W. Norton put out a new edition of *Time on the Cross* in 1989, in which Stan and I wrote an epilogue. The long and short of it was that we were all sucked in by the political argument. But when you started looking at the numbers, the Republican account just did not hold up. So it was very shocking. We got into deep arguments with friends. My wife and I were close friends with Peter Temin and his wife, but the slavery debate led to some discord between Peter and me. So our wives brought us together and said, "You can argue as much as you want in your offices, but once you cross the threshold of either house, forget it." I think, on the whole, we managed not to undermine personal relationships, even though the sometimes-bitter debate that followed the book's publication could have done that. Also, I felt very uncomfortable thinking of slaves as a commodity. It was very hard to talk about it in class. I always felt a sense of embarrassment and felt the need to make it clear that I was not in favor of slavery. The fact that slavery was efficient did not mean that it was good.

RF: I notice that you are close to publishing a collection of interviews with economists. Whom did you speak with for that book and what insights do you expect will emerge about the changing nature of economics during the 20th century?

Fogel: My wife and I are writing a small book called *Simon Kuznets and the Empirical Tradition in Economics*. For the book, we did many interviews. Some of the people we talked with knew Simon well personally, while some of them had little connection to him but were intellectual leaders in economics. We are using some of this material in the book, but there was also a lot of interesting material that simply did not fit. So we decided that we would collect these interviews and publish them separately in a book that is tentatively titled *The Transformation of Economics, 1914-1980: Interviews with Economists*. For instance, we have about eight hours of interviews with Milton and Rose Friedman. Milton had worked closely with Simon, co-authoring an important book titled *Income from Independent Professional Practice*, part of which also served as Milton's dissertation. The interviews with the Friedmans are wide-ranging and provide a superb history of the economy and of the discipline. There is some overlap with the material in their autobiography, *Two Lucky People*, but most of the discussions break new ground.

RF: There's a large gap in your academic CV from 1948, when you finished your undergraduate degree, to the mid-1950s, when you enrolled in graduate school. What were you doing during that period?

Fogel: When I graduated from college, I had two job offers. One was from my father, to join him in the meat-packing business. That would have been quite lucrative. The other was as an activist for a left-wing youth organization. I chose the latter and worked as an activist from 1948 to 1956. At the time I was making that decision, my father told me: "If you really believe in that cause, come work with me. You will make a much higher wage and you could give your extra income to hire several people instead of just yourself." I thought, well, that makes some sense. But I was convinced that this was a way to get me to change my views or at least lessen my commitment to an ideological cause that I found very important. Yes, the first year, I might give all of my extra money to the movement, but every year I would probably give less, and finally reach the point when I was giving nothing at all. I feared I would be co-opted. I thought this was my father's way of indoctrinating me.

So I went to work as an activist. At first, I thought what I was doing was important. But over time, I started to become disillusioned. The Marxists had predicted a depression in 1947-1948. That didn't happen, so they said, it will happen the next year. But it never came. So by the early 1950s, I began seriously reconsidering my position. I had been drawn to Marxism because I thought of it as a science. But it was pretty clear that its "scientific" predictions were wildly off the mark. I was ready to leave the movement, but then McCarthyism started to heat up and that led me to hesitate. I stayed a few more years to fight against McCarthyism. But by 1955 and 1956, the horrors that had occurred under Stalin, which we had all heard about but didn't really believe, were confirmed by Khrushchev. That was the breaking point in a sense. I began to rethink my views and especially my involvement with Marxism. So I decided that I needed to receive more serious training in economics and the social sciences generally and went to Columbia.

RF: Did the failures of Marxism to accurately analyze the economic situation in the United States influence you to pursue work that was heavily data driven and empirical?

Fogel: There is no doubt about that. As I said, Marxism was sold as a science, but it became clear that it was not. It was more of an ideology than anything else. My early experiences made me very skeptical of ideologues of any persuasion. I'm willing to be surprised, to accept seemingly radical ideas, but there better be data to back up those claims, and Marxism could not provide that type of evidence.

RF: Which economists have influenced you the most?

Fogel: Well, obviously Simon Kuznets would be at the top of the list. The older I get, the more I realize the extent to which my whole outlook on economics was shaped by him. George Stigler had a big influence on me, first as a student at Columbia and then as a colleague at Chicago. I took his price theory course at Columbia. He was an extremely smart man, a great teacher, and had a great wit. I never got heavily involved in monetary economics, but I was certainly influenced by Milton's empiricism. Robert Solow also had a huge influence on me. He provided a framework for looking at growth that was extremely useful in my work. Tom Schelling was another strong influence on me. You couldn't be at Harvard without being impressed by him. He has one of the most probing, original minds I have ever encountered.

I would say, though, that the biggest influence on me has been my graduate students, many of whom I have collaborated with very closely. The story I am about to tell is already in print, but it's worth recounting. It's about a casual lunch that several of us had at the Quadrangle Club. Harry Johnson, Al Harberger, Zvi Griliches, and I were there. During the conversation, Mike Mussa's name came up, and we each said that Mike knew as much about our field as we did. He had processed all this information and theory that he had taken from his classes and synthesized it in a remarkable fashion. But none of us was willing to say that we each knew as much as all four people at that lunch.

On the slavery issue, Claudia Goldin did some really insightful work as a graduate student. Dora Costa's dissertation, which in book form won the Paul A. Samuelson Award, has had a major influence on the study of changes in the process of aging over the course of the 20th century.

Some people are able to carry out their work on their own, but not the type of research I have done or am doing currently. One person can master only so many skills, and for my work you really need to have collaboration with others. I have been very fortunate to have had such a great group of colleagues and students. **RF**

Rooftops and Retail

BY CHARLES GERENA

As the population has decentralized, retail development has moved out of cities into the suburbs

One can imagine how the first residents of Roland Park felt when they moved to this former suburb of Baltimore in the late 1800s. The community has since been incorporated into the city, but it retains the atmosphere of an urban refuge. Its winding streets and rolling hills defy the grid patterns that characterize the city's downtown.

Different, too, is the neighborhood's commercial development. Built in the late 1890s, the local shopping center is a two-story building with a steep gabled roof, narrow leaded-glass windows, and ornamental half-timbers, which blends in with the surrounding Tudor-style architecture. Storefronts that at various times housed a drugstore and a tea room are now occupied by two bank branches, a delicatessen, a French bistro, an antique shop, and professional offices.

"This was a new thing" for suburban residents. "They didn't have to go downtown for every single item," says Robert Hearn, a 17-year resident of Roland Park and a former professor at the Johns Hopkins Institute for Policy Studies. Hearn researched the community's history for the Roland Park Civic League.

Throughout the history of retailing, new formats have emerged to reflect changes in societal preferences, from the arcades in European cities to the regional malls that dominate America's suburbs. Roland Park's shopping center illustrates how retail development has mirrored the decentralization of cities that started in the Northeast and Midwest and spread throughout the United States.

"Some would argue that … it is part of the American psyche to be against cities because that is where evil lives and graft and corruption. It is the rural ideal," notes Michael Beyard, an urban planner and economist at the Urban Land Institute. Beyard contends that government subsidies helped support decentralization and suburbanization, although these trends had already been occurring as a result of rising incomes and other factors.

Mean Streets

When most people think about suburbanization, they tend to picture the spic-and-span, cookie-cutter homes that began transforming America's landscape in the 1950s. In fact, the impetus to leave cities and settle the outlying countryside existed long before the days of Ozzie and Harriet.

"Suburbanization has been occurring for as long as we have had cities," notes Brian Berry, a geographer at the University of Texas at Dallas. He has studied urban development for more than 40 years.

Even though American cities were newer and generally smaller than their European counterparts during the 19th century, they became more densely developed as industry took root and European immigrants settled them. Streets were narrow, lot sizes were small, and houses were close to the curb. This pattern of development occurred as much out of necessity as to reap the advantages of economies of scale and agglomeration.

Cities formed near sources of raw materials or around hubs for long-

Roland Park's developers built this shopping center in the 1890s as a convenient place for Baltimore's early suburbanites to shop.

PHOTOGRAPHY: ROLAND PARK ROADS & MAINTENANCE CORP. FILES distance transportation, such as a railroad station or a port along a major waterway. But local travel was typically limited to as far as a horse or one's own two feet could carry a person. "As cities grew, more and more people had to crowd into that limited radius," Berry says. "Competition for land increased and land prices went up," forcing urban development to occur vertically, not horizontally.

Crowding led to public health and safety issues in cities. Diseases like cholera and typhoid fever spread easily, water and sewer systems proved inadequate, and fires occasionally engulfed entire blocks. In the eyes of many, the desire to have more elbow room and better living conditions began to outweigh the benefits of city living.

The same economic and social forces that have shaped people's preferences for housing have also led to changes in retailing. "Merchandising outside city walls began in the Middle Ages, when traders often established markets ... beyond the gates to avoid the taxes and congestion of the urban core," wrote Columbia University historian Kenneth Jackson in a 1996 journal article. Later, enclosed shopping spaces were created to provide a cleaner environment sheltered from the elements, from London's Burlington Arcade (completed in 1819) to Milan's Galleria (built in 1867).

First Wave

The upper middle class and the wealthy led the initial decentralization and suburbanization of the United States during the 19th century. "Social change usually begins at the top of society," noted Jackson in his 1985 book, *Crabgrass Frontier: The Suburbanization of the United States*. "In the United States, affluent families had the flexibility and the financial resources to move to the urban edges first."

This trend runs counter to what the rest of the world has experienced. In France and other European countries, the wealthy concentrated in cities. The suburbs were regarded as undesirable because they housed the urban outcasts who couldn't afford to live in the city.

"In many cases ... the density created so much competition in the housing market that it was very expensive to live there," notes Samuel Staley, director of urban and land use policy at the Reason Foundation. So, shanty towns emerged as an affordable alternative for the poor and working class, built on the outskirts of the city where land was cheaper but close to where the jobs were.

Prosperous Americans often maintained urban residences but they regularly spent their weekends outside the city and summered there to escape the sweltering heat. The task for developers was to make the suburbs attractive for year-round living.

In order for residents to easily return to the city, railroad suburbs were located near a train station. Later, developers built homes at the end of horse-drawn and electric-powered trolleys, earning their communities the nickname of streetcar suburbs.

Along the East Coast, suburbanization started north and west of cities, according to ULI's Michael Beyard. Since they were often located on the fall line, this quadrant was typically at

Raleigh's First Shopping Center

Opening in 1949, the regional shopping center at Cameron Village was, by some accounts, the first large-scale retail facility of its kind built in the Southeast. It was one of the components of a 158-acre planned community built two miles northwest of downtown Raleigh.

At the time, many planned suburban developments had only small neighborhood shopping centers, says Richard Longstreth, an architectural historian at George Washington University. Levittown, Pa., and Lakewood, Calif., were two notable exceptions. "They had the scale to warrant a regional shopping center," Longstreth says. In contrast, the Southeast didn't have the density and growth in population that the Northeast, Midwest, and the West Coast had, so there wasn't need for large-scale development.

Cameron Village was developed on rural land, but within the city limits of Raleigh. Also, the city had been rapidly growing since the early 1900s and drew shoppers from throughout eastern North Carolina.

Developer J.W. "Willie" York modeled Cameron Village's shopping center after Kansas City's Country Club Plaza, notable for its large-scale, tightly managed development, and distinctive, automobile-oriented design. York met the plaza's creator, J.C. Nichols, at the annual meeting of the Home Builders Association in 1946.

York's center opened with three stores and one restaurant. Within eight years, it expanded to 55 stores, attracting Sears and a number of downtown retailers. (The center now boasts more than 90 storefronts.) Eventually, the shoppers who had traveled to Fayetteville Street, Raleigh's downtown shopping district, chose Cameron Village for its variety of retail offerings and parking for 2,000 cars.

They were also attracted to Cameron Village's upscale atmosphere. Store signs were white metal, mounted to the building and backlit, not neon or hanging from hooks. Large canopies protected people from bad weather.

G. Smedes York, Willie's son and chairman of the family business that still manages Cameron Village, says the shopping center was built to be convenient for people living in Raleigh's suburbs. It was oriented to fashion consumers and other specialty segments.

Today, Cameron Village has reinvented itself as a lifestyle center. Its former owner, Atlanta-based Branch Properties, invested $16 million to remove the canopies, build a town square, and give each storefront a distinctive facade to resemble an urban streetscape. — Charles Gerena a higher elevation, making it less prone to flooding. Also, the prevailing winds came from the northwest, blowing pollution from urban factories toward the ocean and away from residents.

Roland Park, one of the earliest suburban developments, fits this description. Built on a series of ridges overlooking Baltimore, the community was marketed to the upper class and upper middle class who lived in toney neighborhoods like Mount Vernon.

"There was the worry of disease and pestilence in the city," describes local historian Robert Hearn. "And, it was cooler out here. ... There wasn't air-conditioning" in residences. Finally, people wanted something different. "If you had big trees and lived up on a hill, that was better than living downtown where everything was brick and stone."

The community's landscape, part of which was laid out by the firm of Central Park designer Frederick Law Olmsted, appealed to potential suburbanites. They also were attracted to its clean water supply, drawn from artesian wells, and its sewer system, built underground versus the open system used in Baltimore.

The first planned developments outside of cities had to provide some of the amenities that urban dwellers were accustomed to. The one thing they didn't re-create was a business district. Stores and factories were next to houses out of necessity in the city, and that was something suburban residents didn't want to deal with again. "At the time, commerce was considered something that detracted from land values," says Richard Longstreth, an architectural historian at George Washington University who has researched the retail decentralization of metro areas.

That's why commercial activity in Roland Park was confined to a single "business block." It would contain "only those businesses which are necessary for the comfort of our residents," noted Edward Bouton, general manager of the development company, in an 1891 letter to a member of the company's board. Saloons and other businesses were banned.

Roland Park's business block is widely referred to as the nation's first shopping center, though some would argue that later developments near Chicago and Kansas City were more representative of the genre. According to Longstreth, the development proved that a collection of retail locations managed by a single owner could add value to a residential suburb. The facility resembled a large country house rather than a commercial building, plus it was set back from the street and had a landscaped front yard.

Not much retail development occurred outside of cities at first. Only a few, small shopping centers like Roland Park's were built through the turn of the 20th century. Aside from the desire to keep commercial activity out of residential areas, suburbs didn't have the customer base to support larger-scale, regionally oriented retail. They weren't densely populated, nor was it easy for people to travel long distances.

Instead, the earliest shopping centers focused on being a convenient source of necessities for the neighborhood's residents, complementing rather than competing with downtown shopping districts. If suburbanites wanted the latest fashions and a broad selection of specialty goods, they made a special trip back to the city to browse its stately department stores and specialty retailers.

Roland Park's developers facilitated such a journey — they built an elevated railway line that could get residents to City Hall in downtown Baltimore in about 30 minutes. In fact, one of the stops on the line was at the shopping center.

Department store operators opened a few suburban locations, but their focus continued to be their flagship stores in downtown shopping districts. Business historian Daniel Raff at the University of Pennsylvania says cities provided the foot traffic needed to create sufficient turnover of their broad inventories.

"The profitability of the company depends on how rapidly the stores sell their inventory and replace it with more merchandise," Raff describes. For a store in the middle of Herald Square in New York, "there is a large enough population of heterogeneous tastes [that] it will be sooner rather than later [when] someone is going to want that special thing."

For the Masses

As white-collar and working-class Americans became more affluent in the early 20th century, Reason's Sam Staley notes, they, too, started seeking housing alternatives. They gradually moved from the crowded tenements of central cities to less dense townhouses to single-family, detached homes with small lots.

Meanwhile, the challenges of city living multiplied. Progressive Era reforms to eliminate poor living conditions, while providing some benefits to residents, often resulted in higher housing costs. A second wave of European immigration and the "Great Migration" of Southern blacks seeking a better life added to the competition for housing. The introduction of the mass-produced automobile in 1908 led to urban congestion and pollution, as well as provided a means for people to venture farther away from cities.

Suburban retail growth picked up in the 1920s, with the development of more ambitious shopping centers containing 10 or more stores and parking for automobiles. "The accelerated rise of controlled residential development just before and particularly after World War I spawned the creation of [a larger] shopping center," wrote historian Richard Longstreth in a 1997 journal article. "These complexes provided numerous goods and services either not available nearby or scattered in less compelling, unplanned nodes along traffic arteries."

Residential and retail decentralization slowed during the Great Depression and World War II, then the exodus from cities accelerated from a trickle to an outpour. Several factors opened suburbia to the masses in post-war America.

First, the establishment of the interstate highway system during the late 1950s and 1960s greatly improved travel compared to the patchwork of state and locally funded roads, encouraging people to use their cars more often and travel farther.

Second, advances in construction enabled the mass production of affordable single-family, detached homes to meet the demand for residential development that had built up in previous decades. The first large residential subdivisions were filled with small, similarly designed homes that were criticized for being "little boxes," geographer Brian Berry describes, but they were viewed by many as a better alternative to the cramped, expensive quarters in central cities. The land surrounding cities was a good place to build these subdivisions because it was usually relatively cheap and unencumbered by land-use regulations.

Finally, efforts by the federal government to encourage home construction and ownership helped support the postwar development boom. These included loans backed by the Federal Housing Administration to both developers and prospective home buyers, and federally guaranteed mortgages for veterans provided under the GI Bill.

Once suburbanization kicked into high gear, communities outside of cities became dense enough to support retail development on a larger scale. The increased mobility of suburbanites also enabled retailers to draw from a wider geographic radius.

Initially, department stores and other retailers opened additional branches to serve growing suburban markets, maintaining their presence in downtowns because they thought cities would continue to thrive, according to Longstreth. Instead, cities became less desirable locations for retail development as they lost population.

As populations continued to decentralize, retailers sought to locate near each other to attract a critical mass of customers. Regional shopping centers emerged and enclosed regional malls followed, offering a wider selection of more specialized merchandise in an attractive environment that competed with downtown shopping districts. They also offered something that was hard to find in land-locked cities — a generous supply of parking. By the 1950s, suburban shopping centers reportedly surpassed urban downtowns in total retail sales.

Back to the Future

Retail development has become closely tied to residential development and the lag between the two has narrowed. Malls need lots of room for large anchor tenants, parking lots for cars, and space for future expansion. So, rather than risk waiting too long for a suburban community to fill in, some retail developers follow the first wave of residential growth to communities where they think more growth will occur in the future.

Today, suburbs have matured into centers of industry and commerce in their own right, extending the boundaries of metropolitan areas far beyond their central cities. They have reinvented the urban aesthetic to reflect today's economic and social realities.

Such changes can be seen in the Baltimore metro region. Roland Park's shopping center continues to offer convenience, but residents also travel outside of the city limits to satisfy their retail needs. There's Towson Town Center, a super-regional mall with 195 stores just five miles north of Roland Park in Baltimore County. Outlet shoppers have Arundel Mills, only 19 miles to the south.

Suburbs have achieved the economic vitality of cities, Sam Staley notes, but without the skyscrapers. Reflecting this evolutionary step, some suburban retail developers are trying to re-create the feel of a downtown shopping district in the form of lifestyle centers. Rather than provide a climate-controlled shopping oasis separated from the surrounding neighborhood, these centers are open to the elements and offer sit-down restaurants and specialty retailers situated in an attractive streetscape. Two such malls have opened in or near Richmond, Va., in the past few years.

Going forward, retailers will continue to evolve. In some cases, that will mean "power centers" anchored by big-box retailers. In other cases, it will mean infill development and redevelopment in cities that are managing to attract new residents — Canton Crossing, a 65-acre, mixed-use development on Baltimore's waterfront, will include street-level retail and restaurants to serve office workers and condo tenants in the complex.

"Retail development is responding to a complex set of values, needs, and preferences," Staley says. "It is a metaphor for the way our communities are changing. In some ways, it is a leading indicator." **RF**

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BookReview

Underground in America

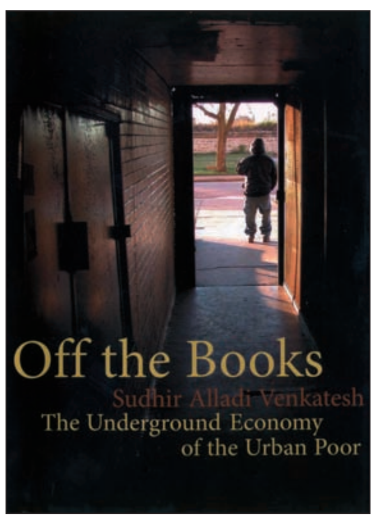
OFF THE BOOKS — THE UNDERGROUND ECONOMY OF THE URBAN POOR
BY SUDHIR ALLADI VENKATESH
CAMBRIDGE, MASS.: HARVARD UNIVERSITY PRESS, 2006
448 PAGES

REVIEWED BY DOUG CAMPBELL

It's been almost two decades since Peruvian economists Hernando de Soto and Enrique Ghersi published *The Other Path*, considered by many to be the seminal work on the underground economy. De Soto and Ghersi described how entrepreneurial Peruvians, in response to the rise of the radical "Shining Path" movement and burdensome regulations that made doing business according to the letter of the law very hard, cultivated an alternative marketplace. They worked as vendors, home builders, and drove most of the buses in Lima.

Eventually, this "informal" economy was estimated to encompass 38 percent of gross domestic product (GDP). Such entrepreneurialism showed the inconsequence of the government's centrally planned, overregulated economy, ultimately weakening the ideology and guerrilla movement behind it.

Now comes what's being hailed as the next landmark narrative on the underground economy. This time, the author is an American of South Asian descent, a sociologist made semi-famous in Chapter Three of *Freakonomics*, the surprise best-seller by economist Steven Levitt and journalist Stephen Dubner, as the enterprising grad student who got his mitts on the ledger of a Chicago drug dealer.



In his first book, *American Project: The Rise and Fall of a Modern Ghetto*, Sudhir Alladi Venkatesh, now an associate professor at Columbia, focused on Chicago's failed subsidized urban housing. In his latest, *Off the Books: The Underground Economy of the Urban Poor*, Venkatesh looks at a single urban neighborhood — a South Side quarter that the author pseudonymously calls "Maquis Park" — and delivers an authoritative account of the current underground economy at work in a major American city.

Though they are not burdened by hurdles as severe as the Peruvian entrepreneurs chronicled in *The Other Path*, the residents of urban Maquis Park, nonetheless, face their own barriers to entry in the formal economy. The neighborhood's physical infrastructure is eviscerated, basic public services are often substandard, human capital is generally low, and official joblessness is rampant. So the people of Maquis Park build their own economy.

This is no ivory tower view. Venkatesh spent parts of eight years, from 1995 to 2003, "hanging out" in Maquis Park. He thinks that his South Asian lineage was an asset; the black residents didn't view him as white or black, but more of a mediator who could be occasionally called upon to settle a transactional dispute. This role helped him get close to his sources. The result is a close-up study of inner-city life that rings authentic.

There is Leroy, the auto mechanic who gets paid for oil changes with trades — a used microwave, sometimes cell phones. "Soccer Mom" Baby "Bird" earns a living as a prostitute, while her neighbor Eunice cleans offices for minimum wage and supplements by selling home-cooked soul food. Even the clergy get wrapped up in the underground economy. Sometimes the pastors negotiate conflicts between pimps and prostitutes; other times they help settle contracts between underground traders. They serve as liaisons between the police and street gangs. They also receive direct benefits for their roles, with cash donations often following the recovery of stolen property, for example. "Like their flock, pastors must also contend with the complexities of life where the underground may be the only available resource," Venkatesh writes.

To be sure, there is no shortage of "legitimate" business. It's just that many of these licit trades get mixed up with illicit ones. The diner owner also vends pirated CDs at the register. The hair stylist subleases a back room to sex workers. They do it for survival because they see no other way. Here's Eunice, the office cleaner who also doesn't report income on food she sells: "Oh, the Lord sees that. Yes, I do live an illegal life in the eyes of God. But he also sees I ain't selling no drugs. I take care of my grandchildren. All that money? It goes to my babies, keeps them in school. I mean, you always going to take care of your children."

The underground economy of Maquis Park is not a political statement. It is, as Eunice describes, a matter of economic necessity. And it is a fairly robust, if not at first obvious, sort of activity. "Beneath the closed storefronts, burned-out buildings, potholed boulevards, and empty lots, there is an intricate, fertile web of exchange, tied together by people with tremendous human capital and craftsmanship," Venkatesh writes. Yes, Maquis Park is brimming with homeless hustlers and barely-scraping-by merchants. But every single one of them is working to make ends meet. They operate in the shadow economy because the official one is both harder to access and provides insufficient income. Venkatesh explains:

> Simply put, it is nearly impossible for residents in Maquis Park to avoid underground economic activity: it is an ever-present threat on the streets, in parks, and other public places; and for the working and poor families, it is always a temptation, given the hardships of living near the poverty line. Recall that, at any point in time, nearly half of the community is out of the labor force, so poverty by itself will force people to seek work outside the mainstream.

Five main types of players operate in Maquis Park, and Venkatesh devotes a chapter to each of them: the domestics, the entrepreneurs, the street hustlers, the clergy, and, finally, the gangs. The aptly named Big Cat is leader of the dominant Maquis Park street gang, the Black Kings, through whom seemingly all underground transactions eventually pass.

Big Cat is keenly aware of his shady status. He yearns to rise in social standing, to be so successful in the underground economy as to be catapulted up to the legitimate one. "He believed the black urban poor must use the underground to amass the necessary political and economic capital to improve their social standing and become influential actors in the wider city." Recognizing that his own welfare depends on his relationship with the community, Big Cat even backs off on some of his most profitable drug-dealing operations. But he is doomed from the start. It's not giving anything away to note that Big Cat never realized his goal. News of his death opens Chapter One; his funeral serves as the book's conclusion.

The portrait that emerges of Maquis Park is one of shaky, tense alliances, risk, and the ever-looming possibility of death. Bargaining is a way of life between the groups — not just bargaining over goods and services but bargaining to keep the underground economy afloat. Marlene, the nanny and sometimes community watchdog, meets with Big Cat and Pastor Wilkins to hammer out a sort of peace pact. Their agreement allows unfettered drug and prostitution activity in their park while children are in school or in the late-night hours. But when kids are playing, illicit activity is to cease.

In such cases, the underground economy of Maquis Park works, but it's safe to say residents would eagerly give it up for the certainty of the official economy. Venkatesh is mostly sympathetic to his sources, and he devotes many passages to their resourcefulness. But he has no illusions about their plight. The further Maquis Park residents burrow into the "shady" economy, the less likely they are to build credit and human capital that would propel them into the official economy.

Unlike Peru of the 1980s, the regular economy of the United States is a far more desirable place to be. The tragedy is that some Americans find it hard to move into that world. The informal economy can be more lucrative and the barriers to entry often lower. One might not find the underground economy worthy of celebration, but its existence is imperative to understand. Not only is the American underground economy significant in size — some estimates put it at roughly 10 percent of official GDP — studying it can tell us much about how markets, both legal and illegal, work.

Not only is the American underground economy significant in size, studying it can tell us much about how markets, both legal and illegal, work.

How accurately *Off the Books* renders these events remains somewhat unclear. This is a minor quibble, but because Venkatesh has changed names of people and locations, his reporting is impossible to verify. In a footnote, Venkatesh explains that Columbia University guidelines require that "risks to human subjects" are minimized, a practice that has become standard at research universities around the country. There is otherwise no reason to doubt that all the people and places he describes are genuine, but readers are justified in approaching the text with a healthy amount of skepticism.

Off the Books undoubtedly will show up on social science syllabuses in campuses across the country. Many economists already have placed it on their recommended reading lists. Venkatesh's work is not quite an academic text, yet it is much more than a simple community snapshot. He may get a bit ham-fisted in repeating his theme: that activities in the underground and over-ground economy are inextricably intertwined. But it's an important point. *Off the Books* lucidly describes the urban underground in all its interlocking alliances and complicated angles. Perhaps next we can begin to deal with the problem at a level equivalent to its complexity. **RF**

District Economic Overview

BY ANDREA HOLMES

The Fifth District's economy expanded at a more modest pace in the third quarter, as the continued deceleration in housing activity was joined by further weakening in the retail sector. News from District labor markets remained generally upbeat though, with a steady increase recorded in third-quarter payrolls. Also, third-quarter readings from manufacturing and services establishments were mostly positive across the board.

Housing Activity Slows

Residential real estate activity slowed further in the third quarter, with the National Association of Realtors reporting a 1.5 percent decline in Fifth District home sales. Consistent with the latest data, District realtors noted that new construction and home sales had softened further across most markets. Illustrating this, a District of Columbia agent described that area's housing market as "horrible," and added that sales were down 25 percent from a year earlier. Keeping with the downshift in sales volume, dwindling demand continued to draw down the pace of home price appreciation in many areas. Third-quarter District home prices were only 5.4 percent higher compared to a quarter earlier, the lowest quarterly growth rate since early 2003.

Labor Markets Expand

Fifth District labor market conditions remained generally solid outside of a slowdown in retail hiring. Compared to the second quarter, districtwide payrolls advanced 1.1 percent in the third quarter. Demand for bilingual employees was strong, as evidenced by a Richmond, Va., agent who noted that further strengthening in the area's economy had helped boost demand for employees fluent in Spanish, especially in the transportation and health care industries.

The Fifth District's economy expanded at a more modest pace in the third quarter.

According to the Bureau of Labor Statistics, another large inflow of new entrants to the labor force was recorded in the third quarter, pushing the District's unemployment rate up 0.2 percentage point to 4.5 percent, slightly below the 4.8 percent rate posted a year ago.

Services Revenues Strong

News from Fifth District service-providing firms remained upbeat, with third-quarter measures of employment and wage growth expanding at a healthy clip over the period and revenue growth outpacing that of mid-2006. Contacts at professional, scientific, and technical firms indicated that demand strengthened late in the third quarter. An executive at a financial services firm in Baltimore, Md., attributed his clients' bullishness in part to the recent drops in energy prices.

Activity at Fifth District retail firms contracted further, however, with contacts reporting a continued deceleration in third-quarter sales activity. Executives at two building supply chains noted that sales growth at District stores eased as new residential construction softened. The pace of sales also cooled at furniture and home accessories stores in central Virginia, according to an industry contact in Richmond, Va. In labor markets, retailers continued to trim employee levels and wages over the period. District contacts from both service-providing and retail businesses noted that price growth moderated from July to September.

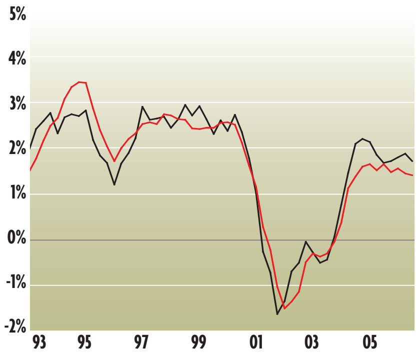
Manufacturing Rebounds

The Fifth District's manufacturing sector rebounded strongly in the third quarter, following a drop-off in momentum during the second quarter. Indicators that were generally lackluster at midyear, such as growth in factory shipments and new orders, had picked up considerably by September. In response to the pickup, District manufacturers added employees and extended hours, as evidenced by the length of the average workweek and factory employment activity, both of which expanded strongly. Among industries, contacts in electronic, plastics, and printing and publishing reported the strongest growth in demand over the period. Manufacturers reported that raw materials and finished goods price growth moderated to a degree from July to September, but they anticipated a somewhat faster rate of increase moving forward. **RF**

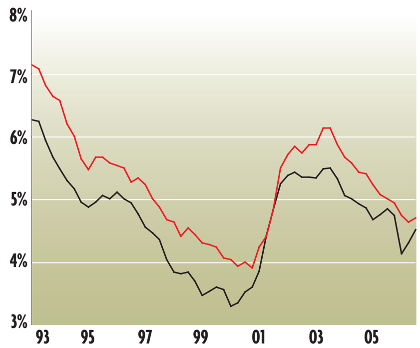
Economic Indicators

	3rd Qtr. 2006	2nd Qtr. 2006	Percent Change (Year Ago)
Nonfarm Employment (000)			
Fifth District	13,673	13,636	1.7
U.S.	135,595	135,128	1.4
Real Personal Income ($bil)			
Fifth District	910.7	904.1	2.6
U.S.	9,490.0	9,416.0	3.8
Building Permits (000)			
Fifth District	54.2	64.2	-15.1
U.S.	437.9	529.5	-23.9
Unemployment Rate (%)			
Fifth District	4.5%	4.3%	
U.S.	4.7%	4.6%	

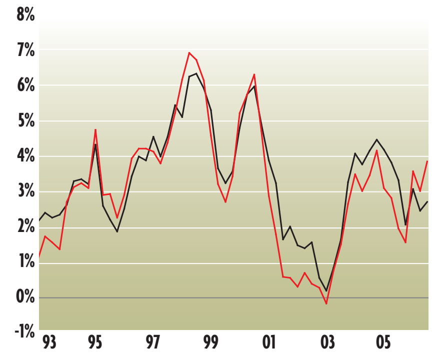
Nonfarm Employment
Change From Prior Year
First Quarter 1993 - Third Quarter 2006



Unemployment Rate
First Quarter 1993 - Third Quarter 2006

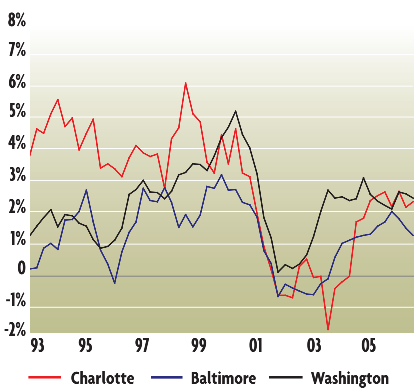


Real Personal Income
Change From Prior Year
First Quarter 1993 - Third Quarter 2006

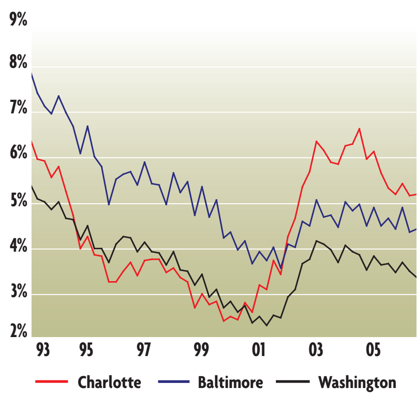


Fifth District — United States

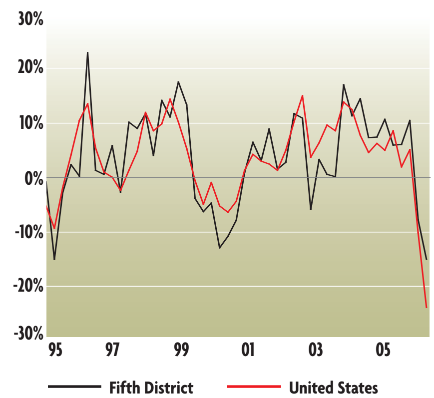
Nonfarm Employment Metropolitan Areas
Change From Prior Year
First Quarter 1993 - Third Quarter 2006



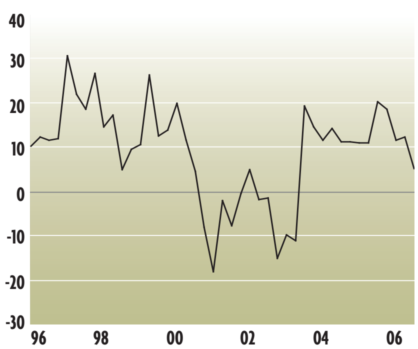
Unemployment Rate Metropolitan Areas
First Quarter 1993 - Third Quarter 2006



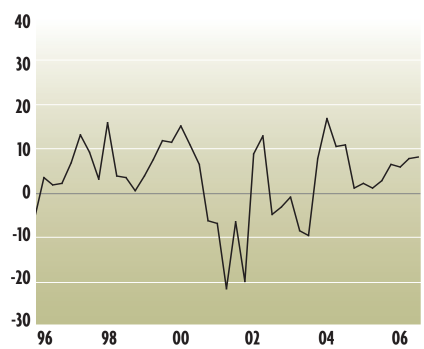
Building Permits
Change From Prior Year
First Quarter 1995 - Third Quarter 2006



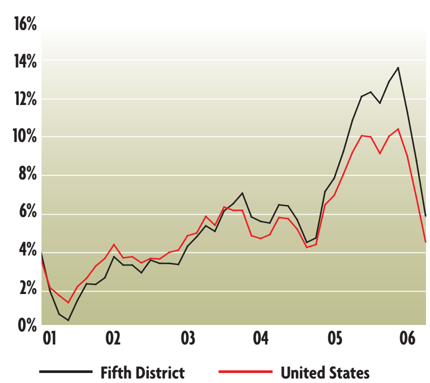
FRB—Richmond Services Revenues Index
First Quarter 1996 - Third Quarter 2006



FRB—Richmond Manufacturing Composite Index
First Quarter 1996 - Third Quarter 2006



House Prices
Change From Prior Year
First Quarter 2001 - Third Quarter 2006



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 house prices are not seasonally adjusted (nsa); all other series are seasonally adjusted.

SOURCES:
Real Personal 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.
House prices: Office of Federal Housing Enterprise Oversight, http://www.ofheo.gov.

For more information, contact Matthew Martin at 704-358-2116 or e-mail Matthew.Martin@rich.frb.org.

State Economic Conditions

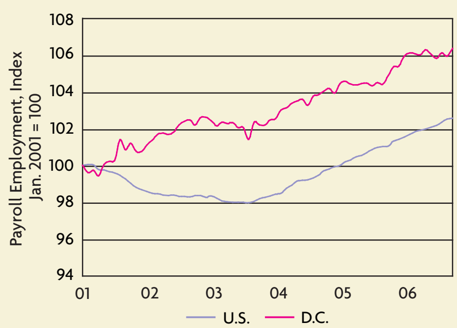
BY MATTHEW MARTIN

District of Columbia

The District of Columbia's economy has slowed of late and most labor market measures of economic performance have been moving sideways. There has been very little in the way of payroll job gains so far this year, while the household survey indicates that the labor force contracted again in the third quarter. The decline in housing activity has been modest compared to neighboring states, but existing home sales in the third quarter were lower than both previous quarter and year earlier totals.

Employment statistics indicate a continuation of modest growth in the third quarter for the District of Columbia. The number of payroll jobs actually contracted by a small margin compared to the previous quarter, though the number of jobs is 1.5 percent higher than a year ago. Most of these gains occurred at the very end of last year and there has been little increase so far in 2006. The District of Columbia's large government sector has not added many new positions over the past year, but there is also some softness evident in the outsized professional and business services sector.

D.C. and U.S. Employment Growth Since Jan. 2001



SOURCES: Bureau of Labor Statistics and Haver Analytics

Periods of slower growth are not uncommon for the District of Columbia. During the most recent recession, for example, job growth actually accelerated, but was then followed by a period similar to that seen recently. In the nation's capital, outright declines in employment are rare; however, the number of people actually living there has declined at times. This may be one reason the household survey reported another sharp drop in the labor force in the third quarter. Over the past year the labor force has declined 2 percent, possibly reflecting population declines within the District of Columbia. However, the area has long had more jobs than laborers, given the large number of commuters.

As is the case in neighboring states, residential real estate activity has declined recently. Existing home sales fell 5.6 percent in the third quarter and have fallen 15 percent since the third quarter of last year. Even though these declines are sharp, they are still smaller than those in both Maryland and Virginia. Residential permit issuance actually rose in the third quarter, though the numbers tend to be volatile from quarter to quarter.

Maryland

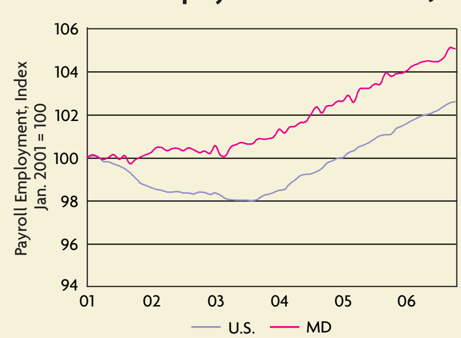
Maryland's economy continues to grow at a steady pace, despite a continued pullback in the state's housing market. Payroll job growth has slowed to just over 1 percent annually, but Maryland possesses the second-lowest unemployment rate in the District. The state's job market remained relatively strong through the last recession. Both new home building and existing home sales dropped sharply in the third quarter, but there is little evidence of a broader impact from housing on the state's economy.

Labor market indicators for Maryland are broadly positive. The third-quarter average unemployment rate of 4.1 percent is 0.3 percent above the second quarter, but the increase reflected more of a jump in the labor force growth rather than a decline in employment. As it stands, the unemployment rate is still marginally lower than a year earlier and is the second-lowest rate among all jurisdictions in the District. Job growth from the establishment survey has been steady, with gains of 1.1 percent at an annual rate in the third quarter equal to the rate of increase since the third quarter of last year.

Maryland's job performance has outpaced the national labor market in the last several years. Since the beginning of 2001, the number of persons employed in the state has increased 5 percent against slightly more than half that amount for the United States as a whole. The difference is entirely due to the lack of job losses during the recession and weak recovery early in the decade. Since 2004, however, job growth has been faster nationally.

Other than Virginia, no other state in the District has seen as sharp a pullback in residential housing as Maryland.

MD and U.S. Employment Growth Since Jan. 2001



SOURCES: Bureau of Labor Statistics and Haver Analytics

The decline in activity has been notable for both new residential construction and sales of existing homes. In the third quarter, permit issuance was 15.8 percent below the year-ago level compared to a 19.4 percent drop in existing home sales. The decline in activity has slowed house price appreciation, though the 7.6 percent increase at an annual rate in the third quarter was the second-largest gain among all jurisdictions in the District. Prices are also 13.3 percent higher than a year earlier, on average, suggesting that further slowing might be forthcoming.

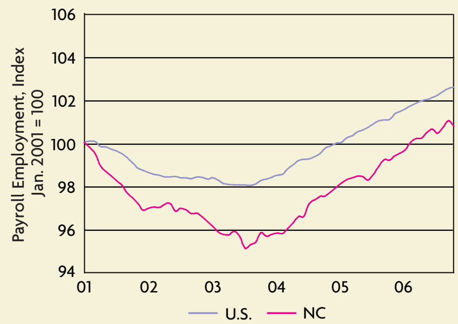
North Carolina

The North Carolina economy is performing well, though the pace of expansion appears to have moderated in the second half of the year. Labor market data are generally positive even though the rate of job growth slowed in the third quarter. The state is likely to see fewer new jobs for all of 2006 compared to the previous year despite fewer manufacturing job cuts. By contrast, housing markets in the state have shown considerably more strength than those in every other jurisdiction in the District, including a substantial increase in third-quarter existing homes sales.

Labor market data for the third quarter were generally positive, though various indicators present something of a mixed picture. Payroll employment slowed in the third quarter to 1.1 percent, down from 1.9 percent in the second quarter. However, compared to a year earlier, growth remained robust, with a 1.9 percent increase that was nearly identical to the second-quarter rate. Additionally, the household survey was more optimistic, with large gains in both employment and the labor force. Growth in the latter was stronger, causing the state's unemployment rate to average 4.8 percent in the third quarter, up 0.3 percent from the prior period.

Despite good job growth throughout 2006, North Carolina remains a trailing state by at least one measure. Current employment levels in the state are only fractionally higher than levels at the beginning of 2001, about the time national employment reached a prerecession peak. Even South Carolina has surpassed the previous employment peak by a larger margin, despite having a higher unemployment rate from the household survey. Unlike the establishment survey data shown in the chart, North Carolina's household survey shows much stronger growth over the same period, outpaced only by Virginia over the same period within the District. While differences between what the two surveys measure account for much of the difference in measured employment, the growing disparity in the two measures suggests future data revisions. The establishment data will be revised early next year as part of an annual process. In North Carolina's case the revision will likely improve the employment picture by increasing payroll employment figures from a year ago.

NC and U.S. Employment Growth Since Jan. 2001



SOURCES: Bureau of Labor Statistics and Haver Analytics

Although there is some slowing in residential real estate markets, there has not yet been an overall pullback across the state. New building construction peaked earlier in the year and has since slowed. Third-quarter permits were sharply lower than second-quarter levels and 7.5 percent below than a year earlier. However, existing home sales have held up well, rising 5.3 percent in the third quarter at an annual rate and they remain nearly 10 percent higher than a year ago.

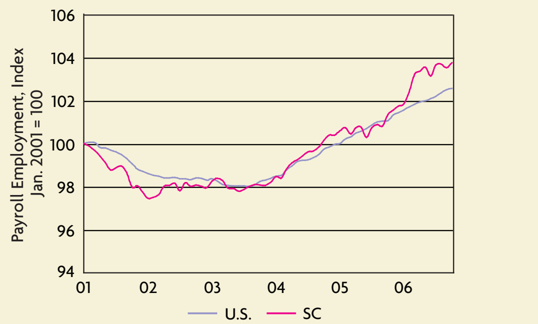
South Carolina

Solid employment growth so far this year and more resilient real estate markets than most have improved the economic outlook for South Carolina. Admittedly, the state has more room for improvement than others in the District, especially with an unemployment rate that remains above 6 percent. However, that figure is now more than half a percentage point lower than a year ago amid job growth in excess of 2.5 percent over the past 12 months. As with North Carolina, the manufacturing sector remains the primary weight on economic growth, though at least job losses have slowed so far in 2006.

Employment growth slowed to 1.1 percent in the third quarter, down from 3.4 percent in the second. However, there was little change in the rate of growth over the past year, which actually ticked slightly higher to 2.8 percent. At 6.4 percent, however, the unemployment rate is the highest in the District, even though payroll job growth has actually been better than average since the last recession. Employment in South Carolina is now nearly 4 percent higher than it was in early 2001, outperforming the national economy. Most of the difference between the two is due to net job growth in 2006. As job growth has accelerated, the labor force has expanded more quickly, keeping the unemployment rate elevated.

Labor force growth has slowed, allowing the unemployment rate to slowly trend lower compared to both the

SC and U.S. Employment Growth Since Jan. 2001



SOURCES: Bureau of Labor Statistics and Haver Analytics

second quarter and a year earlier. In the second quarter, South Carolina had the fastest rate of labor force growth in the District at 3.4 percent. A slight drop in the third quarter still leaves the labor force 1.6 percent larger than a year ago.

Like the rest of the District, new home construction slowed considerably in the third quarter, with new permit issuance down 9.9 percent compared to a year ago. Unlike North Carolina, however, existing home sales also declined in the third quarter yet remained marginally higher than a year earlier. As might be expected, the pullback was sharper in the state's coastal areas, which comprise a significant share of total state activity. The moderating real estate market also slowed house price appreciation, though the house price index rose a respectable 6.5 percent at an annual rate in the third quarter.

Virginia

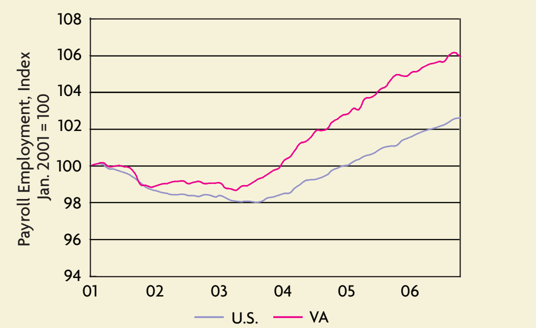
Virginia remains a model of steady, mature growth while also possessing the lowest unemployment rate in the District. Employment growth has slowed this year, but with an unemployment rate hovering near 3 percent and modest labor force growth, some slowing was inevitable. Activity in the state's residential real estate market has declined sharply so far this year, with both existing and new home sales sharply lower than last year. Price growth has also slowed, though broader impacts on the economy are not evident at this point.

The pace of job growth in the third quarter was similar to the second quarter, with a nearly equal pace of growth posted over the past year as well. At 1.5 percent, Virginia's job growth is not the fastest in the District, but the unemployment rate was a District low 3.2 percent in the third quarter, leaving little room for a faster expansion. Even the state's labor force has grown by 1.5 percent over the past year, suggesting a balanced economy that is adding jobs as workers become available to fill them.

The chart shows the strength of Virginia's labor market over time. Employment in the state fell less than that seen nationally during the last recession, with a faster pace of growth since the recession, helping the state easily outperform the nation as a whole. As it now stands, employment in the state grew 6 percent since early 2001.

The sharp pullback in the state's residential real estate market remains the one sector that is under pressure. The decline in existing home sales has been particularly sharp and the 24.4 percent fall in sales since last year is the fastest rate of decline in the District. The fall in permit issuance has been even larger, falling 32.2 percent since the third quarter of last year. Not surprisingly, house price appreciation has slowed, but so far it remains positive. The 2.7 percent increase in the third-quarter house price index stands in sharp contrast to the 21 percent increase posted in the third quarter of 2005. So far, however, weaker results in real estate seem to have only a limited impact on the rest of the economy, with even construction employment still expanding at a robust pace thanks to healthy commercial construction.

VA and U.S. Employment Growth Since Jan. 2001

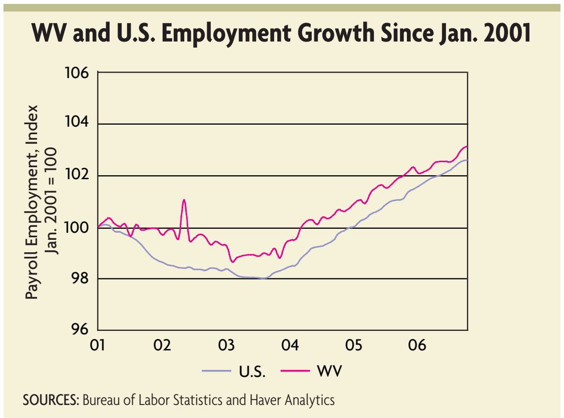


SOURCES: Bureau of Labor Statistics and Haver Analytics

West Virginia

West Virginia's economy continues to expand with some encouraging signs in some sectors. Job growth slowed in the third quarter and residential real estate activity contracted sharply, but the state is still benefiting from elevated energy prices and a newfound stability in manufacturing employment. Both new residential construction and existing home sales contracted sharply in the third quarter, but house price growth accelerated compared to the prior period.

Labor market conditions remained generally positive for West Virginia in the third quarter. Quarterly payroll job growth slowed to 0.8 percent at an annual rate, in part due to a sizable drop in government employment. However, employment in the state's mining sector expanded again and is now as high as it has been at any point in more than 10 years. The manufacturing sector managed to add a few jobs, bringing at least temporary stability to a sector that has been contracting throughout the current expansion.



Measures of labor market activity from the household survey have been volatile recently, but suggest strong growth in the state's labor force. The unemployment rate jumped a full percentage point to 5.6 percent in the third quarter, but the increase owed more to a 3.2 percent increase in the labor force than the 1 percent decline in household employment.

Monthly volatility in the household survey data limits the inference value of the reported figures, but a three-month moving average of the unemployment rate is currently higher than a year earlier by about 0.3 percent.

West Virginia's labor market actually came through the last recession in better shape than the national market. Since then, however, job growth in the state has slowed and the advantage over the national economy has eroded. As a result, employment in the state is 3.1 percent higher than it was at the start of 2001, marginally above the 2.6 percent growth seen nationally over the same period.

Residential real estate markets generally showed further signs of slowing, with existing home sales down 11.5 percent in the third quarter. Comparisons to a year earlier were even less favorable, with a decline in sales of 19.4 percent. Permit issuance has also fallen sharply and is now 21.2 percent lower than a year ago. Despite these figures, house price appreciation accelerated in the third quarter to 8.2 percent, up from 1.8 percent in the second quarter.

Behind the Numbers: Updating GDP

In late October, the Commerce Department announced that the "advance" estimate of third-quarter gross domestic product (GDP) rose at an annual rate of 1.6 percent. It was "a more moderate rate of growth" than seen in the first half of 2006, Commerce Secretary Carlos Gutierrez said in a statement.

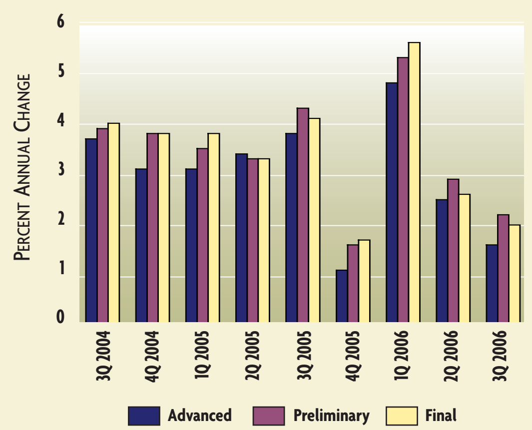
In response, some economic analysts said they were worried about a slowdown. But in November, the department's "preliminary" estimate for GDP growth was revised upward to 2.2 percent, close to the 2.6 percent pace of the previous quarter, and analysts were reassured. Then in late December came the final report on third-quarter GDP — an even 2 percent. Markets were mostly unrattled, however, with the Dow Jones dropping for the day but by only 0.34 percent.

Early GDP results are always subject to change. They are "based on partial and incomplete source data," according to the Bureau of Economic Analysis (BEA). For example, only two months of data are usually available for most data sources 30 days after the close of a quarter, at which time the government's "advance" estimate of GDP appears. So why does the government release these historically inaccurate advance reports if it knows the numbers will inevitably move up or down?

One reason is that the advance and preliminary reports are often close to the mark. According to a BEA study, early estimates "consistently indicate whether growth is positive or negative, whether growth is accelerating or decelerating, whether growth is high or low relative to trend, and where the economy is in relation to the business cycle." The chart provides visual confirmation of this finding. In the past two years, revisions to GDP growth haven't significantly deviated from the overall trend.

GDP Revisions

Despite quarterly revisions, final GDP results are usually close to early estimates.



NOTE: Estimates are in chained 2000 dollars.
SOURCE: Bureau of Economic Analysis

Another reason is that economic analysts know that revisions are coming and hedge their own forecasts accordingly, taking the advance and preliminary GDP figures as just that — early indicators. "We recognize that none of these statistics are as precise as we'd like them to be," says Roy Webb, a senior economist at the Richmond Fed. "We accept them for what they are and make allowances."

— Doug Campbell

State Data, Q3:06

	DC	MD	NC	SC	VA	WV
Nonfarm Employment (000)	690.1	2,588.9	3,991.3	1,910.3	3,737.3	755.3
Q/Q Percent Change	-0.6	1.1	1.1	1.1	1.4	0.8
Y/Y Percent Change	1.5	1.1	1.9	2.8	1.5	1.0
Manufacturing Employment (000)	2.2	138.0	558.5	256.6	297.5	61.5
Q/Q Percent Change	13.1	-0.7	-1.9	-5.4	-0.9	0.2
Y/Y Percent Change	6.5	-1.6	-1.1	-1.4	0.6	0.2
Professional/Business Services Employment (000)	151.4	394.3	455.8	210.7	626.3	59.4
Q/Q Percent Change	-0.1	3.8	2.9	4.0	3.7	3.9
Y/Y Percent Change	2.1	2.2	2.3	2.0	2.6	1.0
Government Employment (000)	233.3	464.7	682.0	338.0	672.8	142.7
Q/Q Percent Change	2.6	-3.2	0.6	5.0	1.9	-1.7
Y/Y Percent Change	-0.1	-0.3	3.0	2.8	1.2	-0.7
Civilian Labor Force (000)	289.8	3,005.7	4,446.7	2,117.6	4,008.4	821.4
Q/Q Percent Change	-3.3	1.8	4.5	-0.7	0.7	3.2
Y/Y Percent Change	-2.0	2.0	2.3	1.6	1.5	2.1
Unemployment Rate (%)	5.8	4.1	4.8	6.4	3.2	5.6
Q2:06	5.5	3.8	4.5	6.6	3.1	4.6
Q3:05	6.3	4.2	5.4	6.8	3.6	5.2
Personal Income ($bil)	28.5	217.0	248.2	111.4	261.9	43.7
Q/Q Percent Change	2.0	3.1	3.1	3.2	2.7	3.8
Y/Y Percent Change	2.0	2.6	2.7	3.4	2.4	3.0
Building Permits	232	6,423	23,868	12,034	10,357	1,205
Q/Q Percent Change	9.4	-70.2	-45.2	-31.6	-61.2	-13.1
Y/Y Percent Change	27.5	-15.8	-7.5	-9.9	-32.3	-21.2
House Price Index (1980=100)	644.61	533.27	326.43	309.64	463.42	231.09
Q/Q Percent Change	4.0	7.6	6.5	5.5	2.7	8.2
Y/Y Percent Change	11.3	13.2	8.4	7.8	9.9	6.3
Sales of Existing Housing Units (000)	10.2	110.0	242.6	119.2	136.0	31.6
Q/Q Percent Change	-5.6	-5.3	5.3	-2.7	-5.6	-11.5
Y/Y Percent Change	-15.0	-19.4	9.7	0.7	-24.4	-19.4

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, 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, Q3:06

	Washington, DC MSA	Baltimore, MD MSA	Charlotte, NC MSA
Nonfarm Employment (000)	3,003.2	1,304.1	808.9
Q/Q Percent Change	1.3	-0.4	0.1
Y/Y Percent Change	2.4	1.2	2.3
Unemployment Rate (%)	3.2	4.5	4.7
Q2:06	3.0	4.0	4.5
Q3:05	3.4	4.4	5.2
Building Permits	6,522	1,785	6,442
Q/Q Percent Change	-49.6	-61.6	-17.5
Y/Y Percent Change	-16.6	-28.3	5.7

	Raleigh, NC MSA	Charleston, SC MSA	Columbia, SC MSA
Nonfarm Employment (000)	276.3	289.5	361.5
Q/Q Percent Change	-1.6	-4.3	-0.3
Y/Y Percent Change	2.7	2.9	3.3
Unemployment Rate (%)	3.9	5.4	5.7
Q2:06	3.7	5.1	5.6
Q3:05	4.3	5.7	6.0
Building Permits	832	1,984	1,822
Q/Q Percent Change	-70.1	-41.0	-35.0
Y/Y Percent Change	-29.8	-24.2	-1.3

	Norfolk, VA MSA	Richmond, VA MSA	Charleston, WV MSA
Nonfarm Employment (000)	780.3	622.3	152.2
Q/Q Percent Change	0.2	-2.4	2.9
Y/Y Percent Change	1.7	1.1	1.9
Unemployment Rate (%)	3.7	3.4	4.8
Q2:06	3.5	3.2	4.4
Q3:05	4.1	3.7	4.6
Building Permits	1,600	1,831	69
Q/Q Percent Change	-54.8	-68.7	-60.4
Y/Y Percent Change	-38.0	-31.3	-15.9

For more information, contact Matthew Martin at 704-358-2116 or e-mail Matthew.Martin@rich.frb.org.

Opinion

Milton Friedman and Liberty

BY ROBERT L. HETZEL

Liberty was a fundamental ethical value for Milton Friedman, the Nobel Prize-winning economist who died late last year. Unlike some other classical liberals, however, he did not defend liberty as an absolute right. Rather, he viewed it as a necessary condition for a peaceful and prosperous social order. Central to the functioning of such a society were free markets and limited government.

In 1946, when Friedman began teaching at the University of Chicago, the prevailing intellectual consensus was strongly opposed to markets. For Friedman, free markets depended upon property rights broadly construed: Everyone should have the ability to bring his physical and human capital into competition with anyone else. As Friedman explained, markets decentralize the allocation of resources through the information and incentives provided by the price system. The self-interest of producers assures that the market provides the goods that individuals choose to consume and also that resources are allocated efficiently across competing uses.

Critics of a market-based economy argued that it cannot create a caring society. Such a society depends upon individual acts of kindness and the caring of voluntarily formed groups — family, fraternal, and religious organizations. It would appear logical to add government to this list by placing economic activity under the control of a benevolent government. Surely, replacing the selfish motives of market actors with the selfless motives of government employees would create a more compassionate society.

Friedman followed F.A. Hayek in challenging this logic. The price system economizes on the information needed by individual actors to make decisions optimal for the entire economy. Because the central planner cannot possess all the knowledge required to make a complex economy function, only a free-market economy can create wealth. Moreover, government, by its very nature, is not voluntary; it is coercive. Invariably, supposedly benevolent, egalitarian governments institute policies that primarily benefit those who exercise power, not the masses, as promised. Friedman compared as "controlled experiments" East Germany with West Germany and North Korea with South Korea. In Friedman's view, government needed to wield some coercive power to carry out basic tasks such as national defense, but that power should be held sharply in check.

Free markets were also criticized for not exhibiting the competition necessary for their survival. A decade of high unemployment during the Great Depression followed by high employment during wartime led to the widespread belief that the price system had failed and that only government could provide a remedy. For the public, free enterprise crashed when the banks crashed in the Depression.

Friedman challenged this view on two levels. First, he and Anna Schwartz explained the Great Depression as a failure of monetary policy, not the market system. Second, Friedman spent his life illustrating the usefulness of the competitive market model for understanding economic phenomena — both in the classroom and through books, magazine columns, and television appearances aimed at the general public.

Friedman demonstrated that government intervention in the marketplace frequently produced unintended and counterproductive results. For example, he criticized the wage and price controls imposed by President Nixon on Aug. 15, 1971, predicting correctly that they would lead to shortages. Friedman also relentlessly demonstrated the relationship between high money growth and inflation, arguing that "inflation is always and everywhere a monetary phenomenon." As a result, when monetary policy became inflationary again toward the end of the 1970s, the public no longer believed that private greed created inflation. Fed Chairman Paul Volcker then had the public and political support necessary to implement a policy of disinflation. Without Friedman's continual advocacy of policies to restrain money growth, the United States might have continued to suffer from periodic bouts of inflation and controls that would have destabilized the economy and eroded limitations on government power.

When I was an undergraduate at the University of Chicago in 1964, I heard a speech by a famous political scientist, Hans Morgenthau, who argued that because modern economies are so complicated they require extensive government planning and control. Many years later, I recounted this story to Friedman, who laughed and replied that Morgenthau had accused him of fighting the wars of the 19th century. Friedman willingly accepted the comparison to the 19th century English economists who had defended free trade during the Corn Law debates.

Friedman can rightly be compared to the Enlightenment philosophers of the 18th century, such as Jefferson and Voltaire, as well. He believed that individuals could identify common ground and through reasoned discourse come to agreement — and spent his life engaged in such discussions. If the 21st century is to be an age of human progress rather than conflict between people with different religious and ideological views, it will be because of efforts made by individuals such as Milton Friedman who believed that the world can be a place of reason and prosperity rather than conflict and hardship. **RF**

Robert L. Hetzel is a senior economist and policy advisor at the Federal Reserve Bank of Richmond. He was a student of Milton Friedman's at the University of Chicago.

NextIssue

School Choice

The theory of school choice says that market competition aligns the incentives of school administrators with parents. As a result, schools perform better and kids learn more. But more than 50 years after Milton Friedman popularized the idea, only a few cities have turned it into practice. Results from school-choice programs in Milwaukee, Washington, D.C., and North Carolina are beginning to move the discussion from the theoretical to the practical.

Prediction Markets

Markets are good at predictions, usually proving quite accurate on the outcomes of everything from sporting events to national elections. That's in part because markets are excellent collectors of information, especially compared with more centralized means of gathering intelligence. More and more firms are turning to markets for guidance, and someday even public policy may be based on market predictions.

Jobs Bank

In the 1980s, automakers thought creating a "jobs bank" for displaced workers would yield benefits for all. Employees would get to stay on the payroll until they found another job or retired, and the companies would keep a skilled pool of labor on call for speedy redeployment. But with more people in the jobs bank than expected, the program has proved costly to the Big Three and the effects on workers have been mixed.

Conservation Economics

How do you encourage landowners to keep open space? Tradable development rights provide incentives to participate in conservation efforts.

Interview

We talk with Kip Viscusi of Vanderbilt University about the economic study of the law.

Economic History

The Fifth District has a long history of black-owned financial institutions with a similar goal — to provide financial services to people who wouldn't have access to them otherwise. But do those institutions provide the same type of benefits to consumers in today's more competitive, open marketplace?

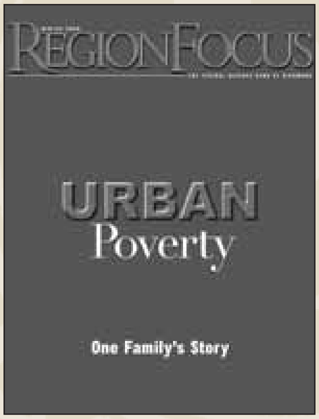
Jargon Alert

Opportunities to buy an asset and then sell it almost immediately for a higher price — what economists call "arbitrage" — do exist. But they disappear quickly.

Region Focus 2006

Highlighting Business Activity in the Fifth District

WINTER 2006, VOL. 10, NO. 1



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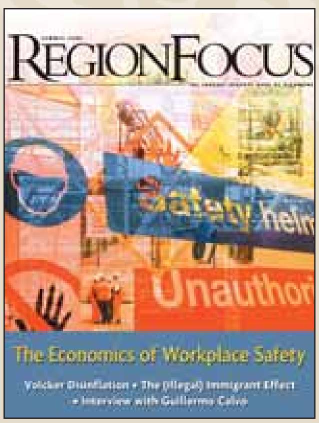

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How North Carolina Became a Banking Giant

Interview
Martin Baily
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