FEDERAL RESERVE BANK OF ATLANTA SECOND QUARTER 2011

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FEDERAL RESERVE BANK OF ATLANTA SECOND QUARTER 2011

inside

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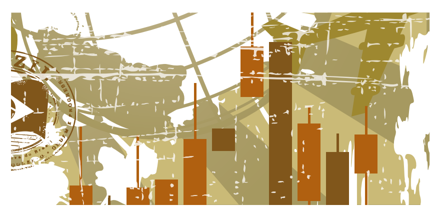

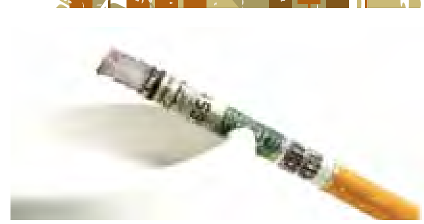

on point

Mother Nature's Vengeance...Again

It's been nearly six years since Hurricane Katrina brought the hammer down on the Gulf Coast. Then, as now, this southeastern region felt the blows that severe weather can deliver and the burdens it can bring to bear on folks who choose this part of the country to call home. The cost of lives lost takes the greatest toll on us all. More than 350 people perished in the recent tornado outbreak that struck Tuscaloosa along with other parts of Alabama and northeast Georgia. And the flooding from the mighty Mississippi left homes destroyed and fields flooded all along the southern swath of river into Louisiana.

The economic impact—while far less important than the loss of men, women, and children—is significant. Disruptions from both the tornado events and the flooding will continue. Opening the Morganza Spillway helped relieve the pressure of flooding on New Orleans and Baton Rouge, but in a sad twist of fate, that relief devastated rural areas. As tragic as it was, the tornado outbreak resulted in temporary disruptions—power is restored, cleanup is under way, and overall (Tuscaloosa notwithstanding), production, transportation, and business activity will soon be back on track. The economic recovery in the Southeast should go on. But the heart of the region—and the heart of its people—hurts once again.

Sunshine and smoke

Florida has long held a mystique in the American mind as a tropical wonderland. While that vision is one the state's leaders are eager to maintain, the recent recession has tempered reality with high unemployment and a punishing housing slump. So when staff writer Lela Somoza began delving into the demographic changes Florida has experienced, she was surprised by some of the innovative strategies under way in the state to lay the groundwork for future prosperity.

"I was surprised at the progress Florida has made in nurturing a competitive biotech/life sciences industry," she said. "While there's still much work to be done, the state has made impressive gains. Orlando, with its 'medical city' research center, is a great example of the way diversification can help build a stronger economy. Although biotech and Florida's other industry clusters are still in their early stages, I look forward to seeing them take shape in the coming decades."

Declines in some other areas of society's fabric are to be applauded, and the falling number of U.S. smokers is one of them. But those who continue to light up are paying a steeper price at the cash register, as politicians hike the tax rate on cigarettes. Staff writer Ed English looked at tobacco taxes to see if deterrence or revenue is the motivation behind making smoking more expensive.

"Politically speaking, smokers can never be sure who their friends are," English said. "One might think that because the Southeast has the lowest cigarette taxes of any region that legislators are their friends. Of the seven states with an excise tax of less than 50 cents per pack, three are in the Southeast—Louisiana, Alabama, and Georgia—and three others are within a half-day drive: Missouri, North Carolina, and Virginia. Conversely, the states with tax rates of more than $2 per pack are relatively distant: Washington, Wisconsin, and a slew of states in the Northeast. But while legislators have given Southeast smokers a break on taxes, that's about as far as the friendship goes.

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Editor's note: Throughout this issue, Southeast refers to the six states that, in whole or in part, make up the Sixth Federal Reserve District: Alabama, Florida, Georgia, Louisiana, Mississippi, and Tennessee.

Photo p. 5: photo (top) by Nahoko Miyake and courtesy of the Lafayette Convention & Visitors Commission; bottom photo p. 5 courtesy of Franks Casing Crew & Rental Tools Inc; p. 27 by Virginia Delaney; back cover (right) courtesy of the Library of Congress photographic archives.

Ruminating about Speculating

PAULA TKAC is vice president and senior economist in the Atlanta Fed's research department.

While the recent rise and ensuing fall in oil prices have not been as dramatic as the episode in 2008 in which West Texas Intermediate crude reached $147 per barrel, the public attention and concern are arguably just as high. Part of the reason is certainly that households are again facing gasoline prices close to $4 per gallon. But this time, for many, the increased cost is coming on top of months or years of financial stress from high unemployment and the modest pace of economic recovery.

As consumers, we never like it when the cost of something we purchase rises, especially something so essential to our daily lives and livelihoods. In economic terms, the short-term demand for gasoline by consumers is relatively inelastic, meaning that over short periods of time like weeks and months, we can't alter our driving patterns much and are left to absorb the extra cost from other parts of our budgets.

When oil and hence gasoline prices rise, an outcry for someone to do something about it usually follows. Most often the "something" is a call to limit the activity of oil speculators. And the "someone" is the Commodities Futures Trading Commission (CFTC), regulator of the exchange-traded oil futures widely used by speculators.

So is speculation the cause of fluctuating oil prices? And if so, wouldn't we, as consumers, be better off if the CFTC took steps to limit speculation? The answer to the first question is: Most assuredly, speculation does drive oil prices, but perhaps not in the way the conventional wisdom would have you believe. As for the second question, I hope to convince you the argument is more complicated than it might seem.

What is speculation?

The *Oxford English Dictionary* defines speculation as "the act of buying and selling goods, land, stocks and shares, etc., in order to profit from the rise or fall of the market value." Compared with investment, speculation is typically thought of as entailing a greater risk of loss and the potential for very large gains. Using this definition, it is clear that speculation occurs in the stock market, the market for collectible baseball cards, and even, prior to 2007, in the market for condominiums in Miami. The market for oil is no different, except that speculators do not have to buy and sell actual oil but can use financial contracts called futures to take their positions and attempt to earn a profit.

Futures contracts are agreements made today to buy and sell oil at a particular date in the future for a predetermined price. For example, the July 2011 West Texas Intermediate Crude futures contract traded at $100 on Friday, June 3, 2011. The buyer of this futures contract agrees to buy oil from the seller for $100 per barrel in July 2011, and the seller agrees to deliver the oil at that time. No money changes hands when the agreement is made. If the price of oil is higher than $100 per barrel in July, the buyer will make a profit since he could turn around and sell this newly acquired oil for a higher price. Conversely, if the price is lower, the seller makes a profit by acquiring the oil more cheaply and selling it to the buyer for $100.

Most futures trading does not entail actual delivery of the oil as in this simple example. Instead, if the futures price is higher than $100 before July, the buyer can enter into an offsetting futures contract as a seller at this higher price and lock in profit without having to worry about dealing with the transfer of the oil.

These futures contracts provide an inexpensive way to speculate on the future price of oil. But speculators are not the only traders in this market. Any firm engaged in the purchase or production of oil as a part of its business can be deemed a commercial trader. Commercial traders use the futures markets to hedge their exposure to the risk of changing oil prices. For example, a plastics manufacturer might buy futures contracts to lock in the price the company will need to pay for the oil it will need in the future, thus lowering the firm's risk of loss if oil prices increase in the meantime. Speculators actually benefit all the commercial traders, by enlarging the pool of active traders and making hedging easier for commercial traders by taking the "other side of the trade" (in this case, selling the plastics manufacturer a futures contract).

Does speculation warp prices?

The CFTC estimates indicate that roughly 43 percent of oil futures contracts involve noncommercial traders (that is, speculators). So, speculators are indeed a meaningful part of the market, and their trading surely affects market prices. But the real question is, in what way? Implicit in the concern about speculation is the assumption that speculation drives the market price of oil away from some "fundamental" price determined by supply-and-demand conditions. But in fact, such a shift needn't be, and generally isn't, the case.

In deciding whether or not to speculate, a trader needs to make an assessment that the current price is too high or too low, an assessment that could be relatively uninformed but in general will be the result of an analysis of market supply and demand conditions, both those currently existing as well as those to come. This assessment requires taking into consideration economic data such as projected growth in emerging economies and the value of the dollar over time, as well as forecasts for the issuance of offshore drilling permits, instability in the Middle East, U.S. regulation on energy usage and vehicle emissions, and so on.

Most assuredly, speculation does drive oil prices, but perhaps not in the way the conventional wisdom would have you believe.

As speculators trade, they help corral all this information, and their best analysis of it, into prices. Those whose analysis indicates the price is too low will buy futures contracts and push the price higher; those who believe the price is too high will sell and help keep the price down or push it lower. Thus the market price we see is the result of an enormous volume of trading based on analysis of economic fundamentals. The market price cannot be driven too far away from what the best analysis indicates; if it did, there would be many well-informed speculators who would be willing to trade to bring it back into line.

To be sure, there have been isolated cases in which a trader has limited success in manipulating a market by driving price away from fundamentals (such as the Hunt Brothers' activity in the silver market in 1979–80). But this kind of manipulation requires a massive buildup of inventories, which we have not seen in the oil market during the recent episodes of price spikes.

So to say that speculation drives prices does not imply that prices are unmoored from economic fundamentals. In fact, it is the very presence of speculation that allows the most information and the best analysis to influence the market price.

Imagining no speculators

It's a useful exercise to imagine for a minute what the world might be like without oil speculators. Here's one scenario: suppose that suddenly there was a significant threat of a disruption to the transportation of oil through the Suez Canal sometime during the next three months. In the extreme case, without speculators, the price of oil might not rise to incorporate this possibility. Now suppose that two months later the disruption occurred; the price of oil would rise precipitously. Oil that would have been conserved if the price had risen has instead already been consumed, and new supplies that might have been on the way would now be that much farther from coming to market.

Through their analysis and trading, speculators help to smooth the volatility of prices in response to changing economic conditions and forecasts of future conditions. The effect of any disruption, such as the one considered above, is blunted as consumers and businesses respond to the changing price of oil. Ultimately, these market prices allow the economy to allocate oil to its most efficient and effective use at all times.

For those unconvinced by these economic arguments, it may help to look at some data. Craig Pirrong, a professor at the University of Houston, has run an analysis of oil prices and the trading behavior of noncommercial traders (that is to say, speculators). If speculation by these traders were driving prices, we would expect to see prices rise when

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grassroots

Lafayette, Louisiana

Where Energy Heats the Economy

A saying in the oil and gas business holds that you can't find a drilling rig anywhere without a Cajun on it.

That's probably an exaggeration—but not by much. Since World War II, the energy industry has become the roux of southern Louisiana's economy, as woven into the culture as zydeco and etouffée.

There's no better example than Lafayette. Known as "The Hub City" for its centrality in the southwest Louisiana region of Acadiana, Lafayette boasts more energy-mining jobs than any other entire state in the Southeast, according to U.S. Bureau of Labor Statistics (BLS) data.

"Oil and gas is important, but it's not all of the economy like it was in the '80s," said C.L. "Rusty" Cloutier, chief executive officer of the Lafayette-based banking company Midsouth Bancorp and a former member of the Atlanta Fed's New Orleans Branch board of directors.

Health care, in particular, has grown. Lafayette is the medical and retailing hub of Acadiana. Plus, the city utility's network of high-speed fiber optic cable reaches every home and business in town, one of a handful of "fiber-to-the-home" networks in the country. The network has attracted considerable publicity and a 20-employee satellite studio of a Hollywood digital arts company. It's also a potential seedbed for more economic development.

But petroleum is king. Directly and indirectly, the oil and gas industry accounts for 40 percent of local economic activity, said Gregg Gothreaux, president and chief executive officer of the Lafayette Economic Development Authority (LEDA). According to LEDA, more than 900 oil and gas companies operate in Lafayette, a metro area of 263,000 people.

Those companies tend to welcome high fuel prices. While hefty gas prices take a bite from drivers there just as elsewhere, expensive oil is among the factors that have buffered Lafayette and south Louisiana from the worst of the national recession. Midsouth Bancorp noted in a recent U.S. Securities and Exchange Commission filing that "high energy prices and continued rebuilding from the storms of 2005 in Louisiana and Texas have partially insulated our markets from the full impact of the national recession."

Elevated prices give energy firms more reason to drill, which means more jobs and higher state permitting and tax revenues, said Anthony Greco, an economist at the University of Louisiana at Lafayette.

To be sure, the recession has not completely bypassed Lafayette. Unemployment has more than doubled since the start of the national downturn in late 2007. Still, the metro jobless rate has remained consistently below state and national levels. As of March, in fact, only one metro area in the Southeast had a lower unemployment rate than Lafayette's 6.3 percent—nearby Houma-Thibodaux, according to the BLS. For all of 2010, Lafayette's jobless rate averaged 6 percent, compared to 7.5 percent statewide and 9.6 percent nationally.

Petroleum power

Lafayette is without question the Southeast's energy industry center. As of March, mining employment, as the BLS categorizes the oil and gas jobs, made up 10.4 percent of the metro area's nonfarm employment, compared to 2.7 percent in Louisiana overall and just 0.6 percent in the United States. Indeed, Lafayette's 15,200 energy mining jobs are the most in any Louisiana metro area, according to the BLS, and more than in many entire states including Alabama, Florida, Georgia,

Lafayette, La.

Population	113,732
(Lafayette Parish)	204,963
Median household income	$43,475
Median owner-occupied home value	$152,000

Source: U.S. Census Bureau, 2005–9 American Community Survey

and Mississippi. (Lafayette's total is almost certainly higher than Tennessee's as well, but that state's mining figures include construction jobs and so are difficult to compare.)

The energy industry has fueled prosperity in south Louisiana for decades. Jobs in the industry pay 25 percent above the average local wage, according to a March 2011 report by Mike Zoller of Moody's Analytics. Even better, Lafayette's oil and gas employment includes a hefty number of headquarters and back-office positions, such as engineers and administrators. Those are more resistant to industry fluctuations than blue-collar jobs on rigs, said Eric Smith, associate director of the Tulane Energy Institute at Tulane University in New Orleans.

That resilience came into play recently. The federal moratorium on deepwater drilling in the Gulf of Mexico that ended in October 2010 hurt Lafayette less than expected, Gothreaux said. Still, it had an effect: along with most of the population centers in south Louisiana, Lafayette has lost jobs since March 2010, the last full month before the BP oil spill off Louisiana that triggered the moratorium.

Lafayette's unemployment rate was 5.5 percent in March 2010; it was 6.3 percent a year later. Meanwhile, taxable retail sales in Lafayette Parish in 2010

were down 11 percent from 2008, according to LEDA.

Those economic hiccups are not entirely a result of the moratorium, however. "The moratorium was part of it," Greco said of the recent slowdown, "and it's just the economic times catching up with us as things slow down." He pointed out that wages in the area have stagnated, which combined with higher fuel and food prices to dampen retail spending.

Oil and gas jobs have hardly evaporated. According to LEDA, Lafayette actually gained 200 oil and gas jobs during the May to October 2010 moratorium, because many companies kept workers on to refurbish drilling rigs and to help extract natural gas on land in northwest Louisiana. "In Lafayette Parish," according to a LEDA report, "the heavy concentration of service companies can provide their services just as easily for onshore activities as they do for offshore activities."

What's more, Gothreaux said, Lafayette benefited from harsh lessons learned a quarter century ago. During a punishing slump for local energy companies, Lafayette's unemployment rate soared above 17 percent in 1986 and 1987, according to Haver Analytics and the BLS. The oil companies cut payrolls so deeply that they essentially lost a generation of workers to other industries and geographic areas, Gothreaux said. It was difficult for the companies to hire again when business improved. They didn't want to repeat that history during the moratorium, Gothreaux said.

That caution served Lafayette well. The Hub City placed 11th nationally and second in the Southeast on the Milken Institute's 2010 Best Performing Cities Index, which ranks metro areas by "how well they are creating and sustaining jobs and economic growth."

Another publication last year recognized Lafayette's nascent digital media community. *Southern Business and Development* magazine listed Lafayette

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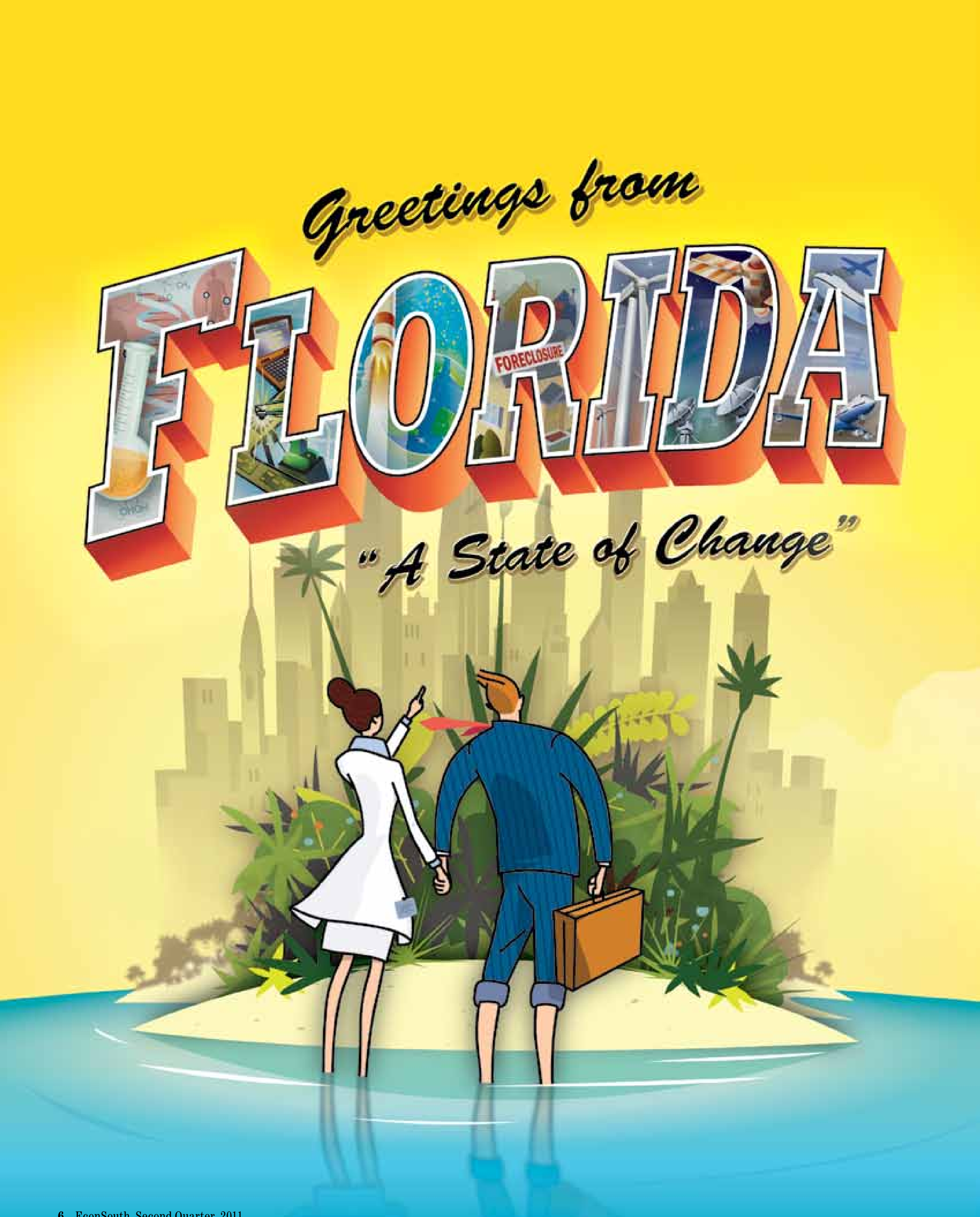

Greetings from
FLORIDA
FORECLOSURE
"A State of Change"

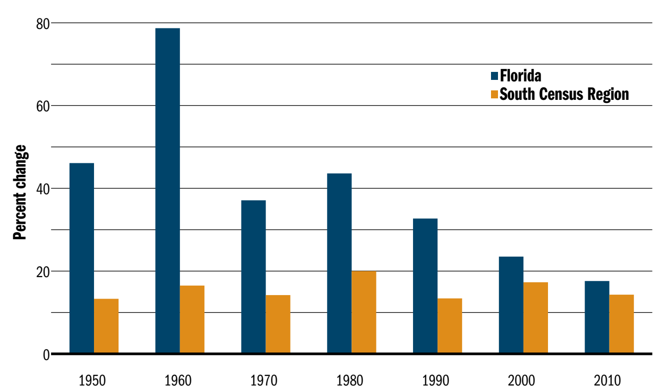
For decades, Florida's prosperity was based on a simple premise: growth. Growth in the population led to a booming housing market, job market, revenue base, and the advantages they afforded. In the wake of a punishing housing slump and slowing population growth, how does Florida begin the next chapter of its sun-kissed existence?

Florida, a state perhaps known as much for its booms and busts as its sandy beaches, has enjoyed at least one relative constant since the 1940s—strong population growth. Lured by the state's mild climate, miles of coastline, relatively low cost of living, and lack of a personal income tax, retirees and job seekers alike formed a seemingly endless stream of new residents. "For decades, it was a one-way road of in-migration," said Sean Snaith, director of the University of Central Florida's (UCF) Institute for Economic Competitiveness. "People came to the state and generally stayed." In the decades following World War II, Florida's population growth consistently outpaced the rest of the South (see chart 1), helping to make it the fourth most populous U.S. state by the end of the 20th century.

The state's healthy population growth also powered much of its economic growth. Indeed, the two are closely intertwined, thanks largely to the population-driven construction and real estate sectors. "Population growth packs a one-two punch for the economy," Snaith said. To start, all those new residents needed a place to live. The demand for homes fueled the state's construction industry, a key element of Florida's so-called "economic triad," which also includes agriculture and tourism. As a result, the state's economy came to rely more heavily on construction-driven growth than did many other states. To illustrate, the most recent data available from the U.S. Department of Commerce show that in 2009, construction accounted for just over 5 percent of Florida's economy, compared to 3.8 percent for the nation.

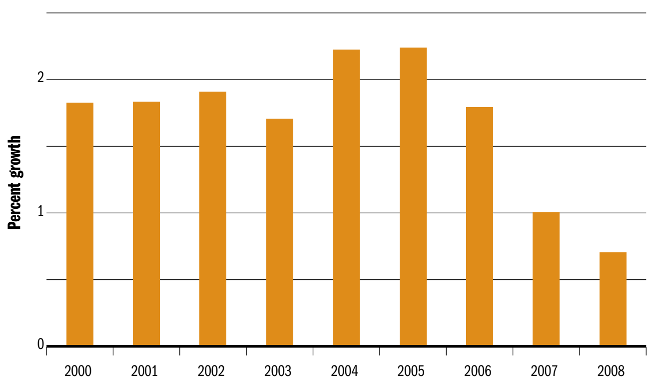
Florida's tax structure is also predicated on strong growth, with state and local governments depending heavily on new residents to fill their coffers as new Floridians fund roads and schools with the property and sales taxes they pay. These tax revenues are especially important in Florida, which is one of seven states without personal income taxes. Indeed, the state's

Chart 1
Population Growth by Decade



Note: Years indicate the final year of the preceding decade. "South Census Region" data include Florida.
Source: U.S. Census Bureau

Chart 2
Florida's Annual Population Growth Rates



Source: U.S. Census Bureau

sales tax makes up three-quarters of general revenue in the state budget, according to the Florida Center for Fiscal and Economic Policy. Other population-linked taxes, such as real estate transactions, are also key funding sources for state and local governments.

Fewer new Floridians

Following decades of impressive gains, Florida's population growth has slowed dramatically in recent years. After increasing 33 percent in the 1980s and 24 percent in the 1990s, Florida's population grew only 18 percent in the past decade, according to the U.S. Census Bureau. While many other states might envy that figure, the seemingly smooth pace of growth masks more significant swings experienced on a year-to-year basis (see chart 2). Indeed, around the peak of the housing bubble from 2004 to 2006, the state gained well over 300,000 new residents a year, according to estimates from the University of Florida's Bureau of Economic and Business Research (BEBR). However, in 2007 and 2008, following the housing crash and the ensuing recession, the state's population growth grew by fewer than 200,000 in each year. The BEBR initially estimated that Florida's population fell by more than 58,000 from 2008 to 2009 in what would have been the first year of decline in more than 60 years. Recent revisions to those estimates, however, suggest that the state actually gained about 73,000 residents during that period, which is still the smallest increase since the 1940s and pales in comparison to the average yearly population growth of about 280,000 seen during the previous decade.

Given Florida's reliance on new residents for economic growth and tax revenues, it is no surprise that the drastic slowdown in its population growth has prompted Florida's leaders, economic developers, and businesses to rethink its economic development strategy.

Most of the blame for the state's sluggish population growth lies squarely with the housing crisis and recent recession. Retirees have long been one of the most significant groups of new residents in Florida, but many of them are either delaying retirement or are waiting out the housing bust before moving to warmer climes. Meanwhile, another key source of Florida's population growth—job-seekers in their 20s, 30s, and 40s—are not eager to move to a state with an unemployment rate near 11 percent, one of the highest rates in the nation.

Modernizing the recipe for success

Florida's flagging population growth in recent years sparked dire predictions of the state's impending implosion, as in the 2007 *Wall Street Journal* article titled, "Is Florida Over?" and *Time* magazine's July 2008 cover, "Is Florida the Sunset State?" Reports of Florida's demise might have been premature, but the slowdown nonetheless prompted state leaders and economic developers to think more strategically about the state's economic growth. "In the past, all we had to do was sit back and wait for people to come," said UCF's Snaith. "Now we have to be more strategic. It will take a concerted effort from the state and different regions to look beyond population growth and tourism for economic growth," he added.

Don Kirkman, president of Florida's Great Northwest, a marketing organization for the 16 counties that make up the northwestern region of the state, agrees. "Florida had been content to let growth support its economy," he said, "but that premise was unsustainable." As the state looks beyond organic, population-driven growth, he says that it must draw more high-tech and advanced manufacturing companies, even though growth in many of these sectors has bypassed the state in the past. The reason, he says, is because Florida "has not been perceived as a state that aggressively supported manufacturing companies." However, that perception may be changing now as northwest Florida, similar to other regions of the state, aggressively markets itself as a prime destination for innovative, high-tech industries. The region is home to seven military installations and, as such, is aggressively working to build an aerospace and defense industry cluster focused on avionics (the electronics systems used on aircraft, artificial satellites, and spacecraft), unmanned systems, and other key industries. Other targeted clusters include transportation and logistics (the region hosts two deepwater ports), health sciences, and renewable energy.

Priming the high-tech pump

Across the state, government leaders and economic developers are actively pursuing those and other high-tech industries, an effort that requires Florida to compete on more than its mild climate, miles of coastline, and relatively low cost of living. The new strategy appears to be yielding modest progress, especially in the state's emerging biotech and life sciences industry, which includes at least eight research institutions throughout the state. A well-known example is Orlando's Lake Nona Science and Technology Park, more commonly known as Medical City. In just over three years, the complex has made a mark on Florida's economy. Anchored by UCF's new college of medicine and health sciences, the complex also houses the East Coast campus of the Sanford-Burnham Medical Research Institute, M.D. Anderson Orlando's Cancer Research Institute, and a University of Florida research facility, as well as new Veterans Administration and children's hospitals.

"Medical City has been an explosive source of growth," said UCF's Snaith, who pointed to successful models such as Silicon Valley in California and North Carolina's Research Triangle Park. According to Snaith, Medical City could one day be the state's "breadbasket for growth." Indeed, a 2008 study by research firm Arduin, Laffer & Moore Econometrics supports his assessment. The study estimates that Medical City could create more than 30,000 jobs and have an economic impact of $7.6 billion by 2018. During that time, the medical school and neighboring institutions could generate more than $13 for every one dollar spent on their development, in addition to providing as much as $2.8 billion in wages and nearly $460 million in tax revenues, said the study.

Florida has successfully recruited other biotech and life science companies to other parts of the state, including the Scripps Research facility in Jupiter, Fla., which is expected to create 6,500 new jobs over the next 15 years and could help position the state as a leader in biomedical research. Scripps Florida is joined by the Max Planck Society, a biomedical research company, the Torrey Pines Institute for Molecular Studies, and the Portland, Ore.-based Gene Therapy Institute.

The state's burgeoning life sciences industry recently garnered praise in an April 2011 Wells Fargo report, *Employment Dynamics and State Competitiveness*, that ranked states by regional competitiveness. That report asserted that "the influx of new medical research facilities will help reinvigorate growth in Florida, helping to diversify the state's economy." Another study, this one by independent research company Battelle, found that biotech employment in Florida grew 18 percent from 2001 to 2008, compared to just 7 percent for the state's total private sector jobs. Further, jobs in Florida's biotech sector bring in an average pay of $55,264 a year, compared to the average private sector pay across all industries of $39, 596, the report said.

Florida also is gaining prominence on the national biotech scene. In 2009, it ranked fourth in the nation in the number of clinical trails held, sixth in the total number of biotech jobs in 2008, and sixth in biotech college degrees awarded the same year. However, it may be too early to measure returns on the state's investment in this and other target industries, says a December 2010 report by the Office of Program Policy Analysis and Government Accountability, titled *The Florida Growth Fund Added Investments in 2010, but It Is Still Too Early to Assess Total Economic Impact*, in part because many of the investments are made in relatively young companies, the report says. A January 2010 study by the same office, *Biotechnology Clusters Developing Slowly; Startup Assistance May Encourage Growth*, noted that although Florida had invested more than $449 million dollars in the emerging biotech industry (as of January 2010) and the state possessed many of the requisite factors, such as university-based programs and government incentives, it still lacked the necessary venture capital funds. These early investments in biotech start-ups are essential to the companies' ability to commercialize their research and create high-wage jobs, the report says.

But even as Florida strives to attract a more diverse mix of high-value-added industries, it faces other challenges too, such as supplying a highly skilled workforce. The state ranks below the national average on key workforce measures such as educational attainment. Indeed, Florida's ability to capitalize on its growing industry clusters depends largely on its ability to produce a highly skilled workforce, say experts like Snaith, who advocates more investments in the state's education system.

Over the longer term, demographers largely agree that Florida's population growth will eventually rebound, pointing to assets such as a warm climate and miles of sandy beaches that have long lured people to the state. But while Florida will continue to draw new residents, it is unlikely to match the robust population growth of the past, at least in the near term. Fortunately, there is still cause for optimism about the Florida economy, according to the 2011 Wells Fargo report, which highlighted the life sciences sector and other high-growth industries in which the state is regionally competitive. Indeed, Florida ranked first in the nation for regional competitiveness, said the report, pointing to the state's "important enhancements to its university system to bring in more cutting-edge research," which "should pay off with an even better mix of high-growth industries in future years." ▮

This article was written by Lela Somoza, a staff writer for EconSouth.

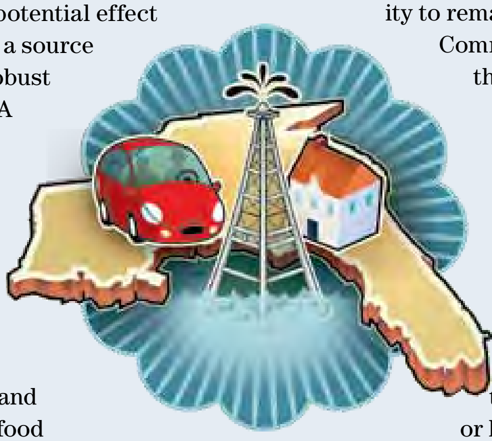
Regional Update: Regional Economy Continues to Recover

Southeastern business contacts described economic activity as advancing modestly in the first quarter of the year. A majority of business contacts maintain a positive outlook regarding future economic activity. Contacts continued to express concern over the impact of higher energy costs on consumer confidence and spending.

Businesses express cautious optimism

Most regional merchants reported that retail activity improved in the first quarter. Sales tax data also reflect positive growth in consumer activity—sales tax revenues are up 6 percent year over year for the combined states of the region. The outlook among retail contacts in the Southeast remains optimistic. However, the rising cost of gasoline and its potential effect on consumer confidence and spending were a source of concern. Automobile dealers described robust sales growth and a strong demand outlook. A few contacts noted that an improvement in consumers' access to credit contributed to the increase in sales.

The region is also benefiting from renewed business and leisure travel. Hotel occupancy rates rose on a year-over-year basis in several of the Southeast's major markets, and convention bookings were also improving. Restaurant contact reports were mixed, and many cited concerns over the rising costs of food products. Airline carriers indicated an increase in both business and leisure travel. Overall, the outlook for tourism remained upbeat.



Real estate remains mired

Unfortunately, there are few signs that residential real estate markets are recovering. Reports from regional homebuilders on new home sales in the first quarter were mixed. Florida and Georgia builders stated that sales were below year-ago levels, while elsewhere in the region sales were similar to year-earlier levels. Homebuilders noted that construction activity remained below last year's level, and inventories eased further. Several residential construction contacts remarked that securing financing remained very difficult.

Southeastern residential brokers indicated that existing home sales growth softened somewhat in the first quarter and were generally similar to year-ago levels. However, Florida brokers were more upbeat, with the majority noting sales gains on a year-over-year basis, which were largely driven by sales of distressed homes. Brokers elsewhere in the region remarked that sales remained below year-earlier levels and were slightly weaker than in our last report. Brokers in the region stated that home inventories eased on a year-over-year basis and that the number and speed of foreclosures coming into the market had slowed. Several contacts mentioned greater demand for rental property. The outlook for sales growth continued to improve, largely driven by positive reports from Florida brokers.

Nonresidential construction activity remained at low levels. However, the majority of contractors indicated that the pace of commercial development was flat to slightly up compared with a year earlier, which is an improvement from previous reports. Backlogs declined on a year-over-year basis. Contacts noted that material prices were on the rise while competition for available projects remained aggressive. Most contractors anticipate activity to remain flat to slightly below last year's level.

Commercial brokers in the Southeast reported that markets continued to stabilize. Vacancy rates remained relatively unchanged from the end of last year, and declining rents were noticed across much of the region. Commercial brokers anticipate a slow recovery.

Manufacturing makes strides

Manufacturers in the region noted strong growth in new orders and production in the first quarter. They also signaled stable or higher levels of employment and indicated that they will be increasing production in the short term. The Southeast Purchasing Managers Index was 64.4 in March, down 0.4 points from February, the first decrease in the index in six months. This index is compiled by the Econometric Center at Kennesaw State University. The decrease is tied to some deceleration in new orders and production, but remains well above 50, which indicates expansion in this sector.

Transportation contacts noted that shipments and tonnage continued to experience modest increases since the last report. Most firms also cited that they have not yet experienced major disruptions in the supply chain from the Japan disaster, but several are anticipating some temporary interruptions—most notably in the auto and information technology sectors.

Jobs market slowly gathers strength

Labor markets continued to recover gradually across the region. Business contacts indicated that their hiring plans for the year are to leave employment levels unchanged or increase them slightly. Many firms noted that they have no problem finding workers with the necessary skills. However, isolated but increasing reports indicated difficulty in finding qualified candidates to fill specialized, higher-skilled positions.

On a month-over-month basis, the Southeast added 22,400 jobs in March 2011. Florida had one of the largest month-over-month gains in the nation and one-third of the state's gains were in the leisure and hospitality sector. Overall, the Southeast's unemployment rate declined to 10.2 percent in March, down 0.2 percentage points from February. Louisiana remains the only state in the region with an unemployment rate (8.1 percent) below the national rate. Total gains in employment were 45,000 for the first quarter for southeastern states, an increase that follows a net gain of 41,000 in the fourth quarter of last year.

Pricing plans face a cloudy future

We continued to reach out to our contacts regarding their pricing plans. Overall, firms' expectations for unit cost increases over the next year continued to rise, with material costs and employee salaries and benefits cited as sources of potential cost pressures. However, reports of price pass-through continued to be mixed across the Southeast and varied based on industry and the presence of competitive pressures. For example, many retailers noted that strong competition was limiting their ability to raise prices. Homebuilders said that they have been unable to pass through material cost increases because of persistent downward pressure on home prices. However, many manufacturers were more successful in increasing prices to their customers.

Energy production, agriculture pick up

April marked the first anniversary of the Gulf oil spill. Though the number of rigs operating in the Gulf of Mexico is still only about half what it was before the oil spill, deepwater drilling permits began to be issued in late February for the first time since last April. Despite a slower pace of permit issuance, overall regional energy production remains healthy. Regional crude oil inventories continued to rise in the first quarter as the industry started to build stocks in anticipation of the summer driving season. Industry contacts noted that the recent international events, including Japan's nuclear crisis and the unrest in the Middle East, have added uncertainty to their outlooks for investment and hiring.

On the important agriculture front, rainfall totals in many areas have improved, though some parts of the region continued to experience varying levels of drought. Farm contacts noted that prices of fuel and feed continued to put pressure on margins, but prices for many of the Southeast's foremost agriculture products remained strong, particularly cotton, soybeans, and beef. Reports indicated that continued strong global demand has contributed to elevated prices for regional agricultural products. ∎

Data Corner: Purchasing Manager Indexes

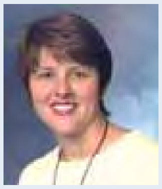
Faced with a collapsing economy during the Great Depression, President Hoover was frustrated with the lack of current data on the economic health of American manufacturers. He approached the National Association of Purchasing Agents (the present-day Institute for Supply Management) about conducting a regular survey at frequent intervals to gauge the well-being of domestic manufacturers. Today, this survey still exists, with its principal output being the Purchasing Managers Index (PMI), a widely known indicator used to gauge the current health of the U.S. manufacturing sector.

Each month, the Institute of Supply Management (ISM) sends a survey to 400 member companies within the United States representing 20 different industries. Managers who engage in production-related purchasing for their organizations are asked to comment on a few factors for the current month compared with the activity of the past month. The PMI is then calculated from five survey questions that measure the participants' perspectives on new orders, production, employment, supplier deliveries, and inventories. Respondents may answer that the month's activity for each component rose, fell, or didn't change compared with the previous month. Thus, the PMI measures changes and trends in these indicators rather than the actual levels of new orders or production.

Because the manufacturing sector is so critical to the rest of the supply chain and has implications for a variety of other sectors, the ISM uses the PMI to draw inferences about not only the manufacturing sector but also the U.S. economy as a whole. As one would suspect given this link, the PMI is heavily linked to the business cycle. Indeed, the PMI was a heavily watched indicator throughout the recent recession and was one of the first signifiers of recovery.

As the PMI is a diffusion measure, a common scale is used to put the results into perspective. If the PMI is above 50, both the manufacturing sector and the U.S. economy are expanding. If it's between 50 and 43, manufacturing activity is contracting, and the overall economy might not be growing. If the index is below 43 on a sustained basis, the manufacturing sector and the U.S. economy are likely to be in a recession. ∎

On the Ground: An Interview with Lesley McClure, Regional Executive at the Birmingham Branch of the Atlanta Fed



What do you see as your top priority in taking over the Birmingham regional executive position? My predecessor, Julius Weyman, worked hard to build a strong network of business contacts, which provides us with timely and relevant information that informs our policy deliberations. My top priority will be to continue developing this network with an eye toward refining our list of target contacts to give us the desired mix of geographic and industry representation. Another priority is to think about ways to improve our emerging processes, such as organizing the information we receive in a more efficient way for our analysts and economists.

What are your initial thoughts with regard to Alabama's overall economic performance? Alabama's economic performance is lagging a bit compared to the nation as a whole. Manufacturing is showing some modest improvement, and it is an important element of our economy here. We will stay attuned to changes, especially any meaningful increase in employment since our state is underperforming the rest of the country in this regard.

How do you envision your role as regional executive over the course of the coming year? Initially, I will be working to meet personally with members of our network and to familiarize myself with the many business, academic, and government organizations in the state that contribute to the vitality of Alabama's economy. I'm also looking forward to getting more involved in the community, with a particular interest in groups that advance financial education initiatives.

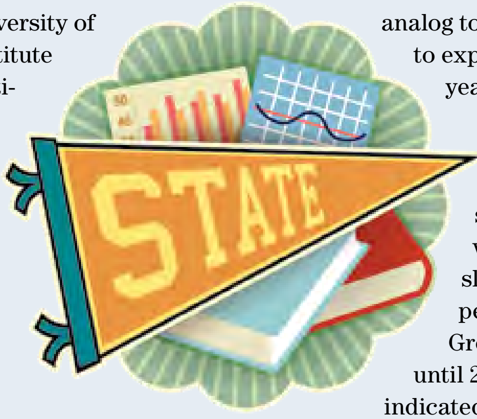
What are some of the information-gathering efforts you intend to use in your region? We have a number of surveys we use to gather information, but my primary focus will be tapping the wealth of knowledge possessed by our network. I am also starting to think about organizations and groups whose forums and events are good sources for information sharing. I look forward to speaking with these groups and building bridges that will be beneficial not only to the Fed's development of monetary policy but also for the business leaders in the region. ∎

University Studies

Overall growth of the nation's economy for most of 2010 was tepid, with gross domestic product (GDP) averaging 2.7 percent for the first three quarters of the year. However, in the fourth quarter, GDP increased to 3.1 percent, indicating that the recovery might be picking up steam. As 2011 got under way, commodity prices began to increase, consumer sentiment softened, and GDP for the first quarter increased but at a very slow pace. Many of our Local Economic Analysis and Research Network (LEARN) members found that the same story held true for their respective states and released updates to their outlooks. Here are a few key findings from their state forecasts.

Florida looks to steady growth

Payroll job growth in the Sunshine State is expected to average 0.4 percent in 2011, and unemployment will not fall below 10 percent until the fourth quarter of 2012, according to the University of Central Florida's Institute of Economic Competitiveness April forecast. The sectors that will experience the strongest growth during the period of 2011–14 are professional and business services (4.8 percent); trade, transportation, and utilities (3.8 percent); manufacturing (2.3 percent); and leisure and hospitality (2 percent).



Researchers at the institute reported that real estate construction had bottomed out in 2009 and new residential starts were expected to grow at a very slow pace. Total starts will grow at an annual rate of 56,800 for the year. Florida's real gross state product, the state-level analog to GDP, is expected to expand 2.4 percent this year, while real personal income will average 3.3 percent from 2011 to 2014. The state's population will continue to grow slowly but is not expected to return to pre-Great Recession levels until 2014. The Institute also indicated that retail sales will accelerate in 2011.

Alabama anticipates modest improvement

The University of Alabama's Center for Business and Economic Research recently released its second quarter 2011 economic outlook. The report described Alabama's economy as modestly improving. The forecast showed Alabama's

GDP growing to about 3 percent in 2011, primarily because of higher commodity, food, and oil prices, as well as the temporary effects of Japan's natural and nuclear disasters. Supply chain issues from Japan have had an impact on the state's automotive manufacturers, resulting in production cuts at both the Honda plant in Lincoln and the Toyota plant in Huntsville.

The center anticipates payroll employment to increase gradually by 0.8 percent during 2011 and the unemployment rate to remain high as people enter the labor force for the first time or reenter it. The report indicated that the major sources of job growth for Alabama will be from large manufacturing firms, particularly in the transportation equipment sector and the state's service-providing employers. Alabama's tax revenues are expected to increase 2 percent this fiscal year. According to the outlook, Alabama's economy will gain momentum from segments such as transportation equipment manufacturing (specifically in the automotive and shipbuilding industries), the state's steel manufacturing industry, and health care services. Finally, the challenges facing the state's funding for services and public education will persist as the effects of the federal fiscal stimulus continue to fade and the pace of payroll growth remains modest. ∎

Econ 101: Household Formation

Households are such a part of our day-to-day lives that we often take for granted their configuration and relative importance in the economy. As defined by the U.S. Census Bureau, a household consists of a group of individuals who occupy a housing unit such as an apartment or house. Households can include related or unrelated members, hence the census's two major categories of households: family and nonfamily.

A household can form in two main ways: individuals living with parents who move out to form their own household (either as independent renters or homeowners), or spouses or other unrelated individuals who decide to move out and live independently.

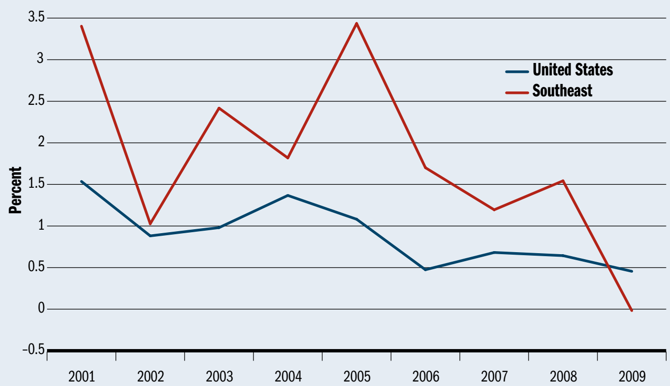
So why is household formation important? Household formation and intrahousehold dynamics have social and psychological importance. From an economic standpoint, they have implications for factors such as consumption, savings, human capital development, and production. Conversely, economic considerations and conditions will in turn effect the construction or destruction of households. (For example, a higher rate of household formation would help absorb the current excess supply of homes.)

The United States has experienced some noteworthy economic trends in household formation. Among these trends:

- From 2008 to 2010, **the number of one-person households has declined dramatically**, and the number of households with seven or more people has risen, according to Census Bureau data. People moving in together is likely a response to the economic downturn, as a weak economy with high unemployment can reduce household formation.
- The composition of the population and how it partitions into households can affect the **resulting resource-allocation decisions** of households (how it spends money, for example).
- In 2010, year-to-year household formation in the United States **dropped to its lowest level** since 1947 (when such data were first compiled). Between 2009 and 2010, roughly 360,000 new households were formed. In 2007, this figure was 1.6 million.

The Southeast has also seen some notable shifts in household formation trends. The **decline in the rate of household formation** is more pronounced in the Southeast compared with the rest of the nation. Essentially, no new households were formed in the region between 2008 and 2009 (see the chart). ∎

Annual Change in Household Formation



Source: U.S. Census Bureau, American Community Survey

Trade Strengthens Ties between China and Latin America

Mutual economic interests have caused the trade relationship between China and Latin American countries to blossom in recent years, and the benefits to the participants have been manifold. But how will trade and currency policies—already a source of friction—affect the delicate balance of interests down the road?

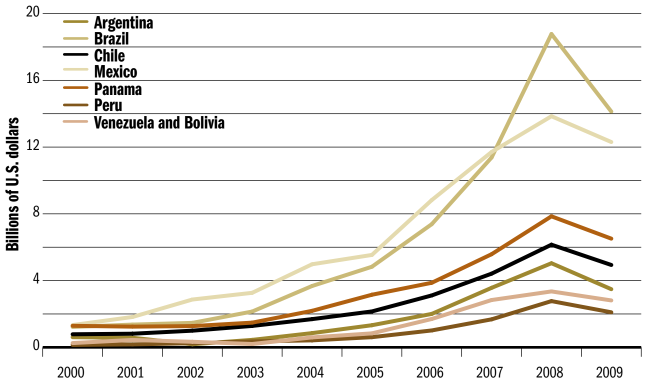
As China's economy has grown, so has its economic influence in Latin America. Chinese imports from Latin America, mostly commodities, have surged and exercised a profound impact on the economies of the exporting countries in the region, while Latin American imports of Chinese products have had a dramatic effect on both consumers and producers. China is now Brazil's top trading partner, Chile's second-largest export market, and Peru's second-largest trading partner. All three of these countries have experienced high levels of economic growth in recent years. Conversely, countries that are not big exporters of commodities to China, such as Mexico and the Central American countries, have not enjoyed the same levels of growth.

China's economic growth has averaged a dizzying 10.3 percent real annual growth since 2000, and it's now the second-largest economy in the world in terms of gross domestic product (GDP) at official exchange rates. In 2000, Chinese trade with Latin America amounted to just over \$12 billion. By 2009 it had grown to around \$118 billion. The Economist Intelligence Unit projects that during the next five years, China's real GDP growth will be between 8 percent and 9 percent, making continuing Chinese demand a key component of global growth and an important market for Latin American exports. The United Nation's Economic Commission on Latin America and the Caribbean (ECLAC) forecasts that by 2015 China will surpass the European


SHANGHAI
上海
CHINA
PEOPLE'S REPUBLIC
BEIJING
DPMAF · DPF · BRAZIL
CLAS.
PRAZO.
BRAZIL
ORDEM E PROGRESSO

Chart 1

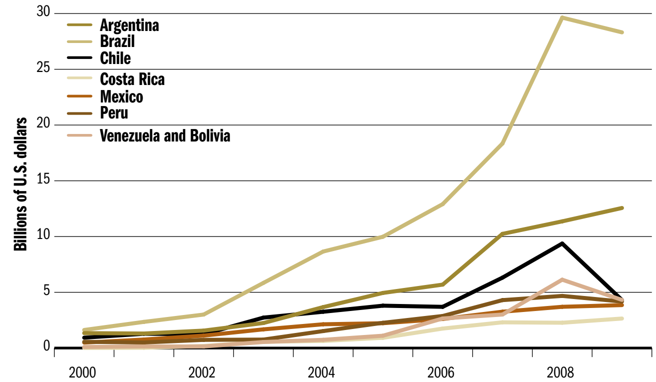
Latin American Exports to China



Source: International Monetary Fund, Direction of Trade Statistics

Chart 2

China's Imports from Latin America



Source: International Monetary Fund, Direction of Trade Statistics

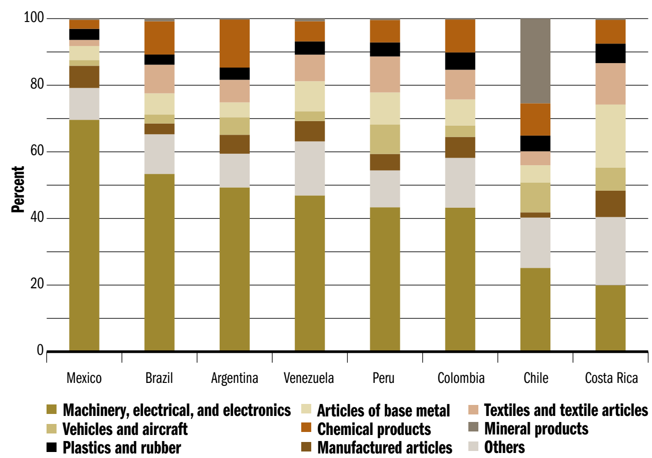
Union to become Latin America's second-largest export market after the United States and that by 2020 China will purchase nearly 20 percent of the region's total exports.

Chinese demand for Latin American exports played a vital role during the global financial crisis and recession. Unlike previous downturns, Latin America's economies were strong when the recession hit, with solid domestic macroeconomic fundamentals (such as low fiscal and current account deficits and a greater degree of exchange rate flexibility), low levels of short-term foreign debt, and high levels of international reserves. Chinese demand for commodities meant that exporting economies enjoyed growing volumes and high prices for their products. Not coincidentally, the Latin American countries with the highest levels of exports to China, including Brazil, Chile, Peru, and Argentina (see chart 1), were the countries that recovered fastest from the recession.

In recent years, imports from China have also risen dramatically in the region, particularly for Brazil, Mexico, Chile, Venezuela, and Argentina, a rapid rate of increase slowed only by the economic crisis in 2009 (see chart 2). These imports from China are concentrated in processed and manufactured goods (see chart 3). China is also investing in energy and mining projects throughout the region.

Chart 3

Latin American Imports From China



Note: Data are for 2010.

Source: Inter-American Development Bank

The progress of processed goods

When it comes to trade between China and Latin America, the region has a clear comparative advantage with respect to primary products (raw materials and resources used in the manufacturing process), but other factors also affect the composition of trade. China imposes barriers to trade, including relatively high tariffs and directives from state-owned firms that prioritize the purchase of domestic goods. The restrictions on trade also tend to increase with the degree of processing and value added of the traded good. For example, Argentina found itself in a trade dispute with China when it tried to export soya oil instead of raw soybeans to China. When its shipments were deemed unacceptable because of alleged sanitary concerns, Argentina relented and went back to shipping soybeans. Finally, China's foreign exchange policies, which hold down the value of the Chinese yuan, serve to increase the price of the Latin America's exports to China. Taken together, these restrictions complicate efforts to expand exports of more processed and manufactured goods.

An export boom based on only a few primary products is not without risks, however. A significant slowdown in China would have a significant impact on growth in Latin America, as trade and investment flows would diminish. Furthermore, beyond the fact that an export boom based on only a few primary products leaves that country vulnerable to price volatility, countries undergoing a natural resource boom are vulnerable to the so-called resource curse, also known as Dutch disease, which has the effect of diverting investment from other economic activities. (For a detailed description of the resource curse, see "Brazil's Oil Discoveries Bring New Challenges" in the first-quarter 2011 issue of *EconSouth*.) In short, Latin American countries face their share of challenges when it comes to diversifying the narrow range of goods they currently export to China.

Whereas Latin America exports mainly primary products to China, its imports from China are primarily processed goods, which have more value added and require more inputs of labor and capital. Most imports from China are in machinery and electrical and manufactured goods (see chart 3). This trade asymmetry is a concern in Latin America as primary products are finite, their value added is limited, and their potential impact on long-term development could also be limited if the revenues from these resources are not allocated wisely.

Chinese demand for Latin American exports played a vital role during the global financial crisis and recession. Unlike previous downturns, Latin America's economies were strong when the recession hit.

Latin America-China trade: A tale of two regions?

As a recent report by the Inter-American Development Bank (IADB) emphasizes, emerging markets are leaders in global growth and now account for 75 percent of world demand growth, up from 50 percent in previous years. Those countries whose trade is concentrated where growth is strongest—primarily emerging Asia—are reaping the benefits of higher prices for their commodities and stronger capital inflows. The IADB calls these countries the "Brazilian cluster," which also includes such countries as Argentina, Chile, and Peru. Paulo Sotero, the director of the Woodrow Wilson Center's Brazil Institute summarized this relationship bluntly when he said in a news report, "Brazil probably would not be an emerging market and emerging country today without its trade relationship with China. You cannot understand Brazil's economic growth without trade with China."

In contrast to the Brazil cluster, the IADB report groups the countries of Central America and the Caribbean with Mexico in the "Mexican cluster." These are countries with greater trade exposure with the United States and other industrialized countries and more generally tend to be commodity importers (Mexico's petroleum exports being an exception). Their dependence on slower-growing regions for trade, tourism, investment, and remittances has contributed to a slower recovery from the global recession. Furthermore, the IADB argues that these two clusters of countries are on different growth trajectories, as it sums up in the report's title: *One Region, Two Speeds?*

The factors that contribute to these "two speeds" are described in great detail in Kevin P. Gallagher and Roberto Porzecanski's 2010 book, *The Dragon in the Room: China and the Future of Latin American Industrialization*, which describes how Latin American exports to China are concentrated in a few countries and in a small cluster of commodities. The authors note that the top 10 commodity exports from Latin America to China represent 91 percent of all commodity exports and 74 percent of total exports to China. The top five commodities represent 75 percent of commodity exports to China and 60 percent of total exports from Latin America to China. Of these top five commodities (see chart 4), four countries dominate the list: Argentina, Brazil, Chile, and Peru. Thus, when describing the region's commodities boom, there is a group of countries that are "winners."

For a country like Mexico, which is not a major commodity exporter to China but does compete directly with China for manufactured exports, the picture is far less rosy. Gallagher and Porzecanski looked at the degree to which China is a competitive

ECONSOUTH NOW PODCAST

Dan Breznitz of the Georgia Institute of Technology discusses China's role in global commerce in an interview. On frbatlanta.org, select "Podcasts."

The Brazil-China Relationship

Bilateral trade between Brazil and China soared between 2000 and 2010, going from $2 billion to $56.2 billion in that period. Besides surpassing the United States as Brazil's largest trading partner, China also became Brazil's largest single foreign direct investor in 2010, at $17 billion, up from the 29th largest just one year earlier. While Chinese demand has been a key factor in Brazil's economic resurgence, the Brazil-China relationship also has had its share of friction.

Soaring imports from China, which grew 61 percent in 2010 from 2009 levels and 47 percent in the first two months of 2011 year over year, have caused considerable alarm among Brazilian manufacturers and led to growing tensions between the two countries. Of Brazil's exports to China, 84 percent were raw materials in 2010, with iron ore, soy, and crude oil accounting for three-quarters of exports. Meanwhile, 98 percent of imports from China were manufactured goods, led by televisions, LCD screens, and telephones. Chinese foreign exchange policies, which serve to undervalue its currency, combined with the strength of the Brazilian real, have exacerbated pressures on Brazilian manufacturers. The severe impact on Brazil's textile and shoe industries has led the National Industry Confederation to warn about deindustrialization in those sectors. Some manufacturers have succeeded in their pleas for government protection: in December 2010, Brazil increased import tariffs on a list of toys from 20 percent to 35 percent. Brazil has also initiated a number of anti-dumping investigations against Chinese products.

Since the current relationship between Brazil and China is one in which Brazil exports raw materials and imports manufactured goods, Brazil is seeking greater balance. The country seeks to sell more value-added and processed goods to China, and it wants Chinese investment to go beyond natural resource extraction. Ninety percent of foreign direct investment is in natural resources.

On her trip to China in April 2011, Brazilian President Dilma Rousseff signed 22 cooperative agreements that included joint development on agricultural technology and biofuels and research and development in nanotechnology, electricity, and oil. For example, Petrobras, the Brazilian government–owned energy company, has agreed to work with the Chinese companies Sinochem and Sinopec on deepwater prospecting technologies. (See "Brazil's Oil Discoveries Bring New Challenges" in the first quarter 2011 issue of *EconSouth*.) The Brazilian mining company Vale received a $1.23 billion loan from the Chinese Export-Import Bank to build 19 very large cargo ships (dubbed "sea monsters") to transport iron ore. China also agreed to $1.2 billion worth of additional purchases of Brazilian Embraer planes, and Taiwan-based Foxconn was said to be considering a $12 billion, five-year investment in Brazil. Nevertheless, despite these agreements, given Chinese demand for Brazil's raw materials and Brazil's need for investment (not to mention the lure of lower-priced manufactured imports from China), the basic patterns of the China-Brazil trade relationship are unlikely to change any time soon. ■

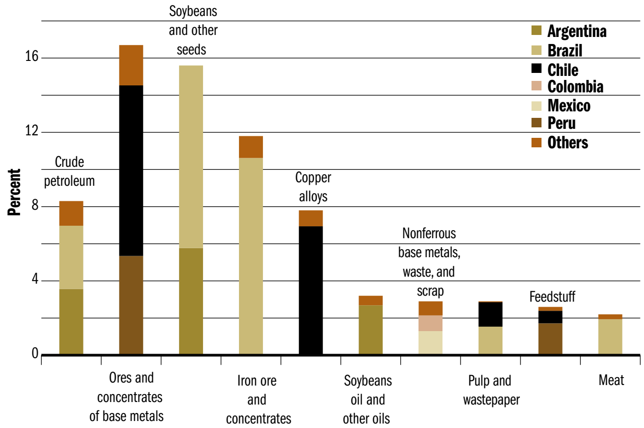
threat to Latin American exports. They labeled China as a direct threat in a given sector if its exports of manufactured goods rose while a given Latin American country's exports shrank, and a partial threat if both countries' exports rose but China's rose at a higher rate. Using 2007 data, the authors found that China was a direct threat to 70 percent of Mexico's manufactured exports and a partial threat to 28 percent of its manufactured exports. In other words, 98 percent of Mexico's manufactured exports (which make up 73 percent of Mexico's total exports) faced a competitive threat from China.

In contrast, China's competitive threat with respect to Brazil is smaller (see the sidebar). Only 39 percent of total Brazilian exports are manufactured goods, and of those, only 9 percent faced a direct threat from China, with 30 percent facing a partial threat. Overall, for Latin America and the Caribbean, Chinese competition is a direct or partial threat to 93 percent of manufactured exports. When the manufactured goods are lumped together with commodities, Chinese competition is a threat to 41 percent of total exports.

A complex relationship develops

Demand for commodities is keeping prices high, bringing benefits to Latin America that are concentrated among six countries. On the other hand, Latin American manufacturers are struggling against very tough competition with respect to exports. While Mexico is the most broadly affected, the rapid rise of imported manufactured products from China has created tension throughout the region.

Chart 4
Latin American Commodity Exports to China



Source: *The Dragon in the Room: China and The Future of Latin American Industrialization* by Kevin P. Gallagher and Roberto Porzecanski (Stanford University Press, 2010)

Clearly, the relationship between China and Latin America is a complex one. Some countries—such as Brazil, Chile, Peru, and Argentina—have seen export earnings soar with trade contributing to high levels of GDP growth. Other countries—such as Mexico and the Central American countries—have not reaped such benefits from trade with China. In fact, countries competing with China in the manufactured exports arena face significant challenges. Brazil's government has made a significant effort to reduce trade imbalances, but it is clear that many of the asymmetries are deeply embedded in the existing trade relationships. The broad contours of the China-Latin America economic relationship are likely to persist in the years ahead. ▮

This article was written by Stephen J. Kay, coordinator of the Atlanta Fed's Americas Center, and Gustavo Canavire-Bacarreza, a research intern at the Atlanta Fed and a PhD candidate in economics at Georgia State University.

Fed @ Issue continued from page 3

they buy and prices fall when they sell. Indeed, Pirrong finds that we do see a bit of this correlation, but based on his analysis the impact of speculative trading raised oil prices by 2.56 percent during 2006–8, a tiny fraction of the actual 123 percent increase. Moreover he finds that speculators were at times selling while prices were rising, contributing to a smaller price increase overall. Finally, his analysis underlies the earlier comment on inventories: inventories of oil fell during the price rise in 2008 and expanded as the price fell, inconsistent with speculative hoarding.

On January 26, 2011, in accordance with the Dodd-Frank Act, the CFTC proposed new rules to limit excessive speculative trading positions in a variety of commodities including oil. Since then, the commission has received nearly 12,000 comments and has not yet issued a final rule. Complicating its task are myriad institutional details that I've not discussed here, including the trading activity that occurs outside of exchanges and the difficulty of distinguishing some speculative activity from hedging-related trading (most often involving financial firms that use futures to hedge other financial transactions).

As I've discussed here, there is currently no clear economic basis and no empirical smoking gun to indicate harmful effects of speculation in the oil market. Perhaps CTFC Commissioner Michael Dunn said it best in January: "To date, CFTC staff has been unable to find any reliable economic analysis to support either the contention that excessive speculation is affecting the markets we regulate or that position limits will prevent excessive speculation. The task then is for the CFTC staff to determine whether position limits are appropriate. With such a lack of concrete economic evidence, my fear is that, at best, position limits are a cure for a disease that does not exist or at worst, a placebo for one that does." ▮

Question & Answer

"The Global Economy Has Significantly Changed"

An Interview with Dan Breznitz of the Georgia Institute of Technology

DAN BREZNITZ

Title	Professor
Organization	Georgia Institute of Technology
Website	www.inta.gatech.edu/faculty-staff/listing.php?uID=15
Other	Breznitz has been an assistant professor at Georgia Tech's Sam Nunn School of International Affairs since 2005. He is also program director at the Center for International Strategy, Technology, and Policy and academic director at Georgia Tech's Sustainable High-Tech Cluster Initiative. Besides *Run of the Red Queen*, he is the author of *Innovation and the State: Political Choice and Strategies for Growth in Israel, Taiwan, and Ireland.*

China's emergence and eventual central role in the global economy have been a source of a great deal of study. But how much of the country's rise was part of a master plan executed by the central government, and how much was a fortuitous exploitation of existing situations? Dan Breznitz, a professor at the Sam Nunn School of International Affairs and the College of Management of the Georgia Institute of Technology and coauthor of *Run of the Red Queen: Government Innovation, Globalization, and Economic Growth in China*, discusses innovation, economic growth, and the lessons China imparts about other emerging economies.

EconSouth: *How would you characterize China's innovation strategy, and how important has it been to China's rapid economic development?*
Dan Breznitz: Let me just start by saying that one of the problems, I think, that we have when we debate China—in the U.S. and in Europe as well—is exactly the words that you use: "China" and "strategy," as if China has "a strategy," just one strategy, and then China leads. While in reality, what we argue in our book is that China's real development is very, very different than the vision of the central government. So there is a strategy, but it's not led by the state. It happened because of state actions and because of the political economy of what is allowed and not allowed in China and what has happened to the global production networks, if you will—how we produce services and things. But it's definitely not what the central Chinese government hoped to happen, and it's obviously not what they're trying to do at the moment, which is probably a problem for China.

ES: *So when you talk about innovation strategy, really you're talking innovation strategies, plural. What are the innovation strategies that have been successful for China?*
Breznitz: For China there has been one strategy that has been truly successful for organizations and for China as a whole. There are variations of the strategy—and indeed, every region of China, or the more successful ones, has a very different model, or subvariant, of that strategy. We call this strategy "the run of the red queen." Basically, it's to accept the technological edge, if you will, and to have the capabilities and capacity to play on that edge without trying to push it forward, which will mean that Chinese companies can immediately offer services, second-generation innovation, based on those new technologies that have been developed elsewhere. So it will be either from a very quick copier and changer of ideas, by doing [something like] Google. I don't know if any one of you in the Fed has an iPhone, but I presume that at least at home you have an iPhone. The iPhone

would never be created without China, the way we think about it. If you think about what happened with the iPhone 4, and the problem of the antenna, and you look into the details, you found out that the Taiwanese, the Chinese producer, had told them that there's going to be problems with this antenna. Therefore, the Chinese counterpart, or partner, of Apple is not just an assembler. It does a lot of the high-level design, it has a lot of knowledge, which Apple does not have, about how to make an iPhone work together, and what the problems will be even if you get specs from Apple.

ES: *So, China's strategy is not to do the new product invention, but rather to work on the innovation on the production side.*
Breznitz: On the production side and on follow up, if you want to call it follow up, or changing innovation as well. So once you develop the product or an idea, and it's obvious that there is a market for it, there is a very large set of second-generation innovation that starts to happen, and all those innovations are the reasons why we can sit in this office. Each one of us has our mobile technology that allows us to do things that 30, 40 years ago, a room full of computers would never allow us to do, and we hold it now in our hand. A lot of what caused this to happen is what we disdainfully called second-generation innovation. But it's true innovation. It's just not—if you want to call it this—invention genesis. And China has been extremely good at going up from the assembly to the logistics, how to produce stuff. And it has been able to do that also because of the way we do things. What people call the global economy has significantly changed since the '70s and '80s. If you want to understand China, you have to understand two things. [First,] you have to understand what has happened and is happening in China, which—let us all remember—is still officially a communist economy, ruled by the Communist Party, and [second,] what happens in the way that stuff is being traded, sold, and produced worldwide, both products and services. Those two processes led to what China is today. And as China grew, it of course changed the way we make our things.

ES: *So is there something about that strategy that other emerging markets can adapt?*
Breznitz: To a certain degree, yes, and some of them have already adapted—we all heard that, at least in the last four or five years. We named Vietnam at least once, but other countries as well. You're the Latin American expert at this table. But to some degree, if you think about other economies growing, you can see that some of them are doing very similar things, if not necessarily in ICT [information and communication technologies], which is the domain which I focused on in this book—commodities, for example, extraction of commodities, mining technologies. Chile didn't invent the mines, but they certainly—from what I know, and you should correct me if I'm wrong—have the leading companies in mining technologies, including remote-mining technologies. So, the Chileans did not invent the remote controls and they obviously did not invent mining, but now they're leading in those technologies.

ES: *So what do China's innovation strategies mean for the United States?*
Breznitz: Let's go to the optimistic side and then go the pessimistic side, okay? So on the optimistic side, they are complementary. So I have a good friend and former mentor called Ed Steinfeld, published a book called *Playing Our Game*, and he is very upbeat about it. We just talked about the fact that if you want an iPad at a price you can actually afford and have it in the market two or three months after somebody thought about it, you must have China. There's no way around it, and therefore we get very large financial gains. China gets a lot of jobs. And supposedly both sides are happy. On the slightly flip side of this, this means we that we have true interdependencies. So in the past, an economist or political scientist talked about economic interdependencies. Norman Angels, just before World War I, explained why we will never have war because everybody will be poor again. But now we have true real interdependency. So on the one side, if we have great leaders who work very carefully on understanding each side and make sure you have a communication level that will prevent those misunderstandings from escalating—because those misunderstandings will happen, probably every week on something—great, and especially if we've re-found our balance in the U.S. and realized how to create jobs, which is a completely different discussion. If we don't, and especially if both sides don't have an agreement about how the world should look two, five, ten years from now, we might be entering a very interesting period, in the Chinese proverb's sense of the word: "May you live in interesting times," which is supposedly a horrible curse. I'm not sure I ever heard it in China, but we claimed it's Chinese, so be it. ∎

This interview was conducted by Stephen J. Kay, director of the Atlanta Fed's Americas Center.

Editor's note: An expanded version of this interview is available online. Go to frbatlanta.org/pubs/EconSouth.

Ta~~r~~x and Nicotine

Seeking any means available to raise revenue, southeastern states—like their counterparts across the nation—have been raising the tax rate on cigarettes, sometimes dramatically. But between smoking-cessation initiatives and the higher cost of lighting up, the number of smokers has been declining. In the long run, how reliable is this revenue stream for state governments?

Once Iowa levied the first state excise tax on cigarettes in 1921, 68 years passed before all 50 states had a similar tax in place. But just as there was no unanimity on the timeline for implementing a cigarette tax, no consensus exists today among states for setting the rate for that tax.

As political battles go, setting the tax rate on cigarettes is a conflict worthy of the proverbial smoke-filled room. Support for raising cigarette tax rates generally comes from lawmakers seeking to offset tobacco-related health costs as well as an array of health organizations hoping to reduce the smoking population. Opposition to taxing tobacco tends to come from lawmakers who vow to fight any new tax, reflecting the antitax fervor of the 2010 national elections. Opposition also comes from industries that stand to profit from tobacco sales, including growers, manufacturers, and retailers.

While each of these groups pursues its own end with the cigarette tax rate, one underlying question persists: What effect will each state's decision have on its bottom line?

Hurting for cash: where to turn?

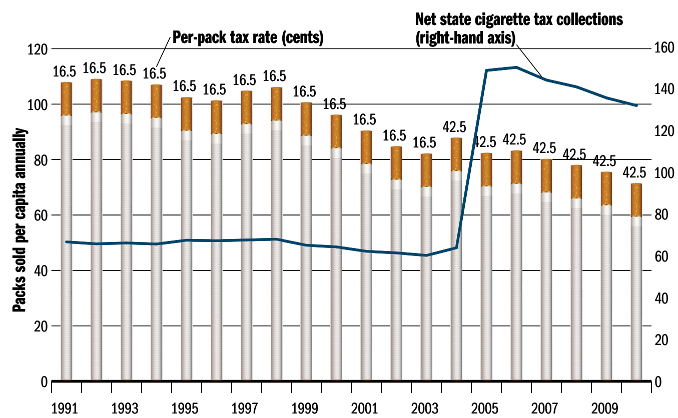
States have increasingly felt a budgetary pinch caused by smaller-than-forecast revenues in the wake of the recent recession and the shifting of funding for some programs from the federal government to the states. According to the Center on Budget and Policy Priorities (CBPP), a nonprofit policy organization, budget shortfalls for 2012 are the norm for the Southeast and the nation. Florida's forecast shortfall of $3.6 billion is equal to 14.9 percent of its 2011 budget. Louisiana has a $1.6 billion shortfall (20.7 percent of its 2011 budget) looming, Georgia faces a $1.3 billion shortfall (7.9 percent), Alabama has to close a $980 million budget gap (13.9 percent), and Mississippi's budget is staring at a $634 million shortfall (14.1 percent). Tennessee's projected 2012 shortfall is not available, but the state had a $1 billion shortfall in 2011, equal to 9.4 percent of its 2011 budget. CBPP forecasts the national average of 2012 shortfall to 2011 budget at 17.6 percent.

Raising tax rates on cigarettes to reduce the deficits is attractive for multiple reasons, according to Mark Robyn, an economist at the Tax Foundation in Washington, D.C.

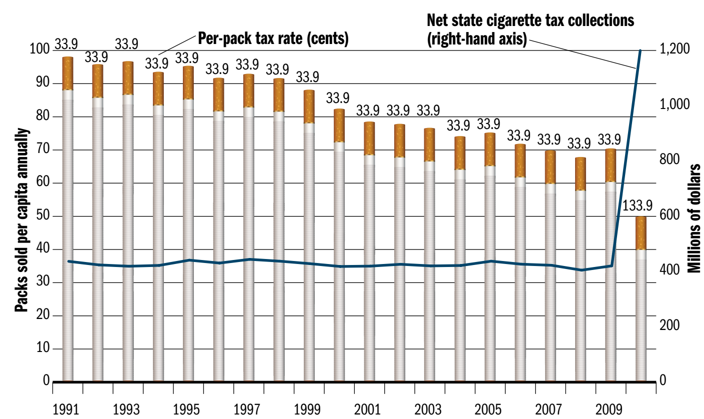
"[Raising cigarette taxes] is a target right now because it's aimed at a not politically favored group," Robyn said. "It's a minority of the population. It's not a very sympathetic group. Politically, it's just very easy." Whereas raising taxes—never a politically palatable undertaking—is especially difficult in a

Southeastern States' Tobacco Sales, Taxation, and Revenue

Alabama



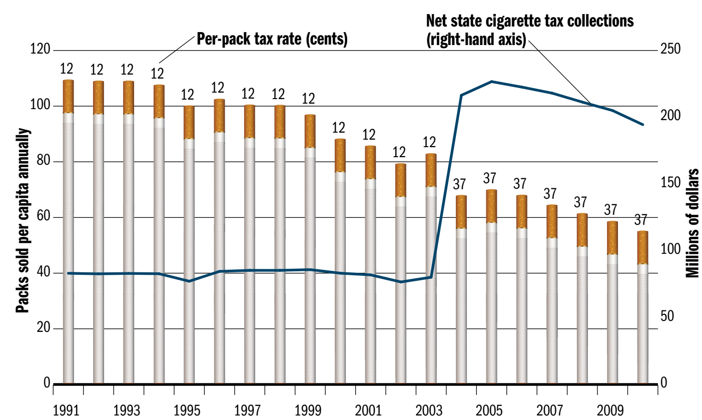
Florida



slow economy, raising the cigarette tax is one of the few taxes that is politically viable, Robyn added.

Tobacco has certainly been in the taxation crosshairs recently in the Southeast. The legislatures of Alabama (House Bill 457) and Louisiana (House Bill 63) have active bills under consideration. Georgia's legislative assembly ended its 2011 spring session without a bill reaching the floor, although Ron Stephens (R-Savannah), backed by a number of health and medical associations, tried to muster support for a tax increase of $1 per pack, raising the rate from $.037 to $1.37, according to WTOC-TV in Savannah. In 2010, Florida accomplished what Stephens sought, a $1 tax hike, from $0.34 to $1.34 per pack. Mississippi more than tripled its cigarette tax in 2009, jumping from $0.18 to $0.68 per pack. The year before, Tennessee enacted a slightly smaller increase, from $0.20 to $0.62 per pack.

Georgia



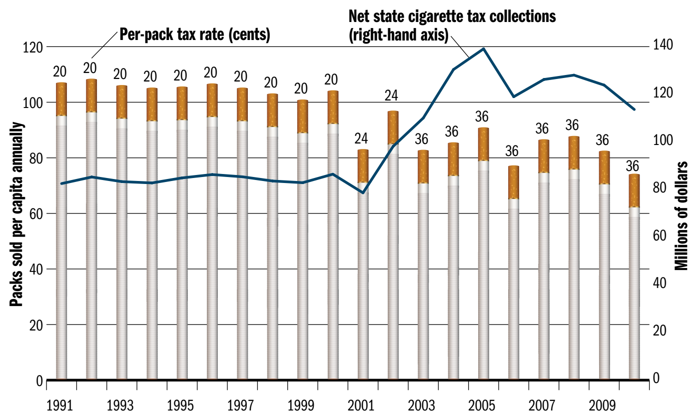
Building the cases

Defenders of these recent initiatives to hike cigarette taxes point to statistics from the Centers for Disease Control and Prevention (CDC) about the costs smokers have on a population. The total economic costs (direct medical costs along with lost productivity) associated with cigarette smoking are estimated at $10.47 per pack of cigarettes sold in the United States, the CDC says. From 2000 to 2004, cigarette smoking was estimated to be responsible for $193 billion in annual health-related economic losses in the United States ($96 billion in direct medical costs and approximately $97 billion in lost productivity), according to the CDC.

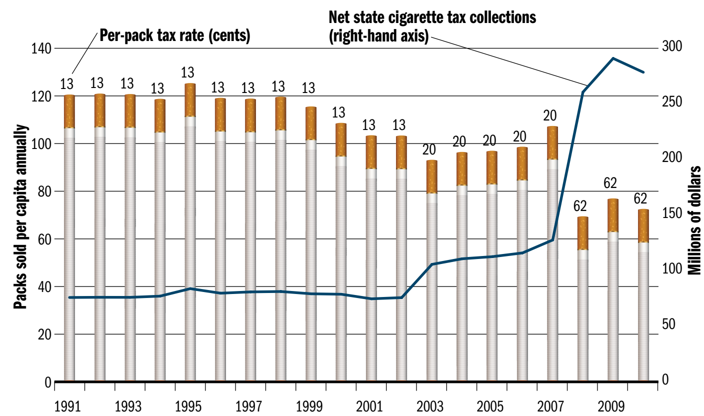
Armed with statistics like these, supporters of the two most recent legislative initiatives on cigarette taxes in the Southeast cited two objectives for a tax hike. On March 31, 2011, Baton Rouge's *Advocate* quoted Frank Hoffmann (R-West Monroe, Louisiana) as supporting the proposed Louisiana cigarette tax hike because the $178 million it would generate annually could be spent on health care. He also feels the hike could discourage young people from smoking. Patricia Todd (D-Birmingham), who proposed Alabama's tax hike, voiced similar reasons. Like Hoffman, she feels that the hike, in addition to providing an estimated $230 million a year for the state's health expenses, could deter young smokers. She described her proposal as a "win-win" in the *Birmingham News*.

Note: “Per capita sales” represents the number of cigarette packs purchased annually.
Source for all chart data: “Tax Burden on Tobacco” report from Orzechowski and Walker

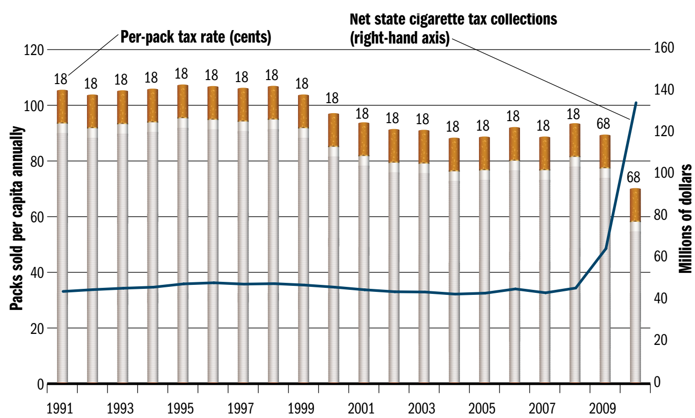
Louisiana



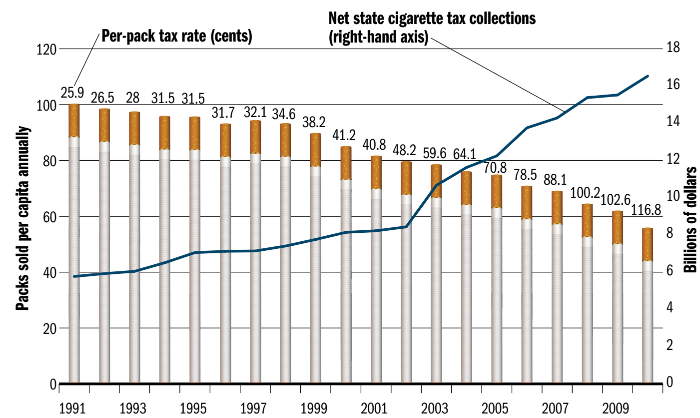
Tennessee



Mississippi



United States



Governors in both Louisiana and Alabama oppose the cigarette tax increase, and reports in the *Advocate* of Baton Rouge and the *Birmingham News* say passage of either is unlikely. Louisiana Gov. Bobby Jindal was quoted in the *Advocate* as saying he would veto any attempt to raise taxes. “Bottom line, we continue to oppose any and all tax increases,” Jindal said.

Higher rates, fewer smokers

The CDC’s Office of Smoking and Health contends that raising cigarette tax rates decreases consumption. The CDC estimates that a 10 percent increase in price reduces overall cigarette consumption among adolescents and young adults by about 4 percent. Data from southeastern states over the last 20 years are consistent with the CDC’s findings. In 1991, Tennessee had a relatively low cigarette tax rate at $0.13 per pack and the highest annual per capita sales at 120.6 packs, according to the *Tax Burden on Tobacco Report*, which quotes the U.S. Department of Treasury’s Alcohol and Tobacco Tax Trade Bureau and is funded primarily by the tobacco industry. Conversely, Florida had the highest rate at $0.34 per pack in 1991 and the lowest sales per capita at 98.2 packs a year. Nationally, the average cigarette tax was $0.26 a pack while per capita sales were 100 packs.

Fast forward to 2010, and the same link between tax rates and the size of the smoking population still existed. In the Southeast, Louisiana replaced Tennessee as having both the lowest cigarette tax, at $0.36 per pack, and highest per capita sales, at 74.3. At the other end of the spectrum, Florida still had both the highest tax rate, at $1.34 per pack, and lowest per capita sales, at 50. Florida's lead in these two categories was solidified in 2009 with a $1 per pack tax hike, which no doubt triggered a dramatic one-year drop in per capita sales, from 70.5 to 50.9 (see the charts).

Observers note that factors other than the cigarette tax rate affect per capita sales. The Tax Foundation's Robyn attributes an unknown portion of the drop to stop-smoking campaigns. Nationally, CDC data show the percentage of Americans who smoke dropped more than 5 percentage points, from 25.7 percent to 20.6 percent, between 1991 and 2009. Overall, the Southeast didn't quite parallel the national decline. While the percentage of smokers in Florida and Tennessee dropped 6.8 percent and 6.9 percent, respectively, two other states remained basically unchanged, with Mississippi's percentage of smokers dropping only 1.6 percent while Alabama's percentage only fell 0.4 percent.

Bruce Ely, a Birmingham attorney who worked with former Alabama Gov. Don Siegelman on tax issues for that state and also represented tobacco companies on excise tax disputes, notes that another factor in per capita sales is the tax rate in neighboring states. He said the states "that are so far behind and below the national average tend to become magnets" for illegal smuggling. "I wish there was a more balanced tax nationally to avoid some of the smuggling and tax evasion we're seeing, both in this state and in other states," he said. "It's just like with tax incentives. The states compete with each other to some extent on being a low-tax state."

A spike and a drop

While the connection between higher cigarette taxes and reduced consumption seems direct, the link between higher tax rates and the states' revenues is not as clear. One prominent trend is that following an increase in a cigarette tax rate, states see a short-term upward spike in revenue, but that spike is typically followed by a gradual reduction, according to data from the Tax Burden on Tobacco report.

After raising its tax per pack from $0.17 to $0.43 in 2004, Alabama's revenue from cigarette taxes peaked at around $150 million in 2005 and 2006. The succeeding years saw a decline each year, until revenue reached $132 million in 2010, a 12 percent drop. Georgia last raised its cigarette tax per pack from $0.12 to $0.37 in 2004. Cigarette tax revenue peaked in 2005 at $226 million. Since then, cigarette tax revenues have declined each year, falling to $194 million in 2010, a 14 percent drop. Louisiana's last cigarette tax rate increase in 2003 was from $0.24 to $0.36 per pack. Cigarette tax revenue in Louisiana peaked two years later in 2005 at $139 million but has dropped in all but one of the succeeding years, to $113 million in 2010, a 19 percent decline. Tennessee raised its cigarette tax rate from $0.20 to $0.62 per pack in 2008 and saw its cigarette tax revenue more than double from $127 million in 2007 to $260 million in 2008. However, after cigarette tax revenues reached $290 million in 2009, they dropped in 2010 to $277 million, a 4 percent decline.

The latest cigarette tax hikes in Florida and Mississippi reveal significant short-term spikes in revenue but are too recent for a post-spike downturn to appear. Mississippi raised its rate from $0.18 to $0.68 per pack in 2009 and saw its revenue more than double, from $65 million in 2009 to $134 million in 2010, while Florida, with an increase to $1.34 in 2010, saw its cigarette tax revenue nearly triple, jumping from $420 million to $1.2 billion.

New school of thought?

The trend of raising cigarette tax rates only to see overall revenue fall is changing the way some states are looking at the issue. The Associated Press reported in March that three states—New Hampshire, New Jersey, and Rhode Island—have considered reducing their cigarette tax rate in hopes of drawing smokers from other states and increasing revenue.

"When you raise rates, you may gain revenue in the short term and lose it in the long term," Robyn said. "The two goals of raising lots of revenue to balance state budgets and reducing smoking are sort of at odds with each other. You can take raising rates to the ultimate extreme, where the tax is $100 a pack. At that point, you're not going to have any smokers left or any smokers buying cigarettes legally. If states truly believe that they're reducing the number of smokers and that's their goal, they shouldn't be dependent on this revenue source because it's going to be dwindling."

So have states extracted as much as they can from cigarette taxation? According to Ely, it depends on the state. "In terms of the high-tax states, I think they're pretty well capped out," he said. "All they can do at this point are things like tax the Indian reservations [which do not pay taxes on cigarettes], tax Internet sales through the Jenkins Act, and try to stop smuggling into their states. Sometimes raising rates can be counterproductive." ∎

This article was written by Ed English, a staff writer for EconSouth.

On Point continued from page 1

In the last decade, each state in the region has enacted some form of smoking restriction."

East meets South...America

The expanding role of China in the global economy is a frequent topic of discussion among economists, but its rapidly evolving relationship with Latin America was on the mind of Stephen Kay, senior economist and director of the Atlanta Fed's Americas Center. Kay foresees a deepening dependence between the two regions in the coming years. "It's obvious that China's rapid economic growth has had a profound impact on Latin America, but until I read *The Dragon in the Room: China and the Future of Latin American Industrialization*, by Kevin P. Gallagher and Roberto Porzecanski, it wasn't clear to me how much some countries stand to win or lose in this process. While Chinese demand for Chilean or Brazilian exports—primarily in the form of raw materials—has contributed to economic booms in those countries, China may be much more of a competitive threat for Mexico, which relies on manufactured exports. The last 10 years have led to some dramatic changes in the hemisphere, and the trade process is just getting started." ∎

Lynne Anservitz
Editorial Director

Grassroots continued from page 5

among 10 digital media centers in the South, along with the likes of Austin, Atlanta, Nashville, and New Orleans.

Pixel Magic, a Hollywood digital effects studio, opened a location in Lafayette in 2009. The state and local governments are vying to attract more digital media firms, partly piggybacking on Louisiana's emergence as a popular locale for shooting movies. Just as important, Lafayette's city-owned fiber network offers unusually inexpensive high-speed data transmission services to every home and business in the city.

Medicine, education sources of job growth

Digital media holds promise for Lafayette. For now, though, local experts cite health care as the first economic staple after energy. Health care jobs account for 13.6 percent of metro area employment, compared to 12.6 percent in the state and 12.9 percent nationally, according to the Louisiana Workforce Commission. Education is another major employment sector. The University of Louisiana Lafayette has 16,000 students and 1,890 employees. And the Lafayette Parish public school system is the area's largest single employer, with 4,568 workers.

Some of the reasons Lafayette and Louisiana have bucked the recession are not ideal. For one, neither experienced the boom-gone-bust as places such as Atlanta and much of Florida did. As Tulane's Smith put it, "We didn't have the jobs to lose."

Lafayette's daily newspaper, *The Advertiser*, opined in an April 2011 editorial that the area still needs to diversify its economy. The paper noted that Lafayette and Louisiana didn't suffer much from the nation's loss of manufacturing jobs in the recession because "we have proportionately less manufacturing." The piece lauded the state for luring some factories recently. "If we can post similar successes in the digital and high-tech area—Pixel Magic in Lafayette is a start," *The Advertiser* editorial concluded, "we'll truly be on our way to the transition from an old-style resources economy to a modern, competitive, diversified one." ∎

This article was written by Charles Davidson, a staff writer for EconSouth.


Our annual report lets you take the wheel.
The new interactive online content features robust navigation, slide shows, and video, as well as expandable sidebar content. Peruse detailed information on factors affecting the southeastern economy including employment, banking conditions, lending, and small business.
Cruise through the 2010 Atlanta Fed annual report at your own speed.
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FEDERAL RESERVE BANK of ATLANTA

closing numbers

20.8

Amount, in gallons, of milk consumed per capita in the United States in 2008

Source: U.S. Department of Agriculture

24.2

Amount, in gallons, of coffee consumed per capita in the United States in 2008

Source: U.S. Department of Agriculture

162,000

Number of U.S. employees engaged in oil and gas extraction in 2007

Source: U.S. Census Bureau

73,000

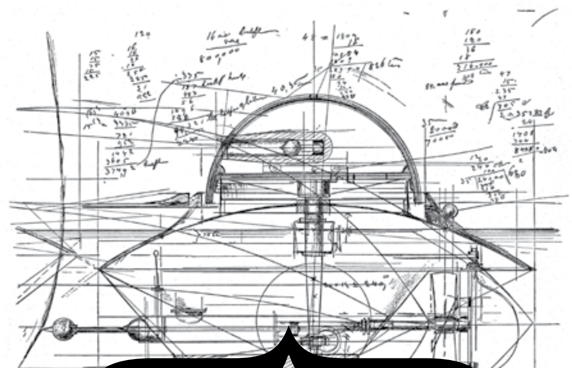
Number of new Florida residents in 2008–9, the smallest increase since the 1940s

Source: Florida's Bureau of Economic and Business Research, as cited in *EconSouth*'s article, "A State of Change"

54

Number of worldwide space launch events in 2009

Source: Federal Aviation Administration (Of that total, the United States had 20 space launches in 2009.)



191,900

Number of U.S. patents issued in 2009

Source: U.S. Patent and Trademark Office

1.34

Amount, in dollars, of Florida's per-pack tax on cigarettes, the highest rate in the Southeast

Source: Tax Burden on Tobacco report, as cited in *EconSouth*'s article, "Tax and Nicotine"

117.9

Amount, in billions of dollars, of China's trade with Latin America in 2009

Source: The Economist Intelligence unit, as cited in *EconSouth*'s article, "Trade Strengthens Ties between China and Latin America"

2.157

Number, in millions, of marriages in the United States in 2008

Source: U.S. National Center for Health Statistics

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While today's public is keenly aware of the dangers of smoking, tobacco producers used to tout the health benefits of smoking, as when women were encouraged to lose weight by smoking instead of snacking (above right).

now and then