

Forefront

New Ideas on Economic Policy from the FEDERAL RESERVE BANK
of CLEVELAND

Healthy Banks, Common Traits

INSIDE:

Student loan debt
and the Fed

Rust belt redefined

Interview with
behavioral scientist
Eldar Shafir



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PRESIDENT'S MESSAGE

Sandra Pianalto

President and Chief Executive Officer
Federal Reserve Bank of Cleveland



The Cleveland Fed is learning more about a small sector of banks called regionals to help clarify regulatory expectations in the wake of the financial crisis.

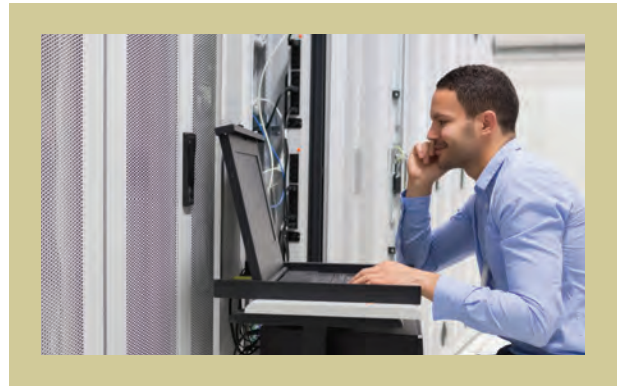
Financial regulatory reform is an enduring topic in *Forefront*, but our knowledge of and perspectives on the subject continually evolve. In the first issue of *Forefront* five years ago, we introduced a framework for systemically important institutions. That framework laid a foundation of macroprudential oversight to help regulators understand and manage emerging systemic risks. In this issue, we zero in on a small but critical segment of the financial marketplace whose connection to strengthening financial stability is just now starting to become known. Regional banking organizations, as the segment is called, are defined by the Federal Reserve Bank of Cleveland as banks with assets between \$10 and \$50 billion.

While we believe that regional banks should not be held to exactly the same standards as the nation's largest banks, we know that they can be systemically important as a group. That is why it is important to understand their role in the financial system and why the health of the financial system could hinge on their success. In the following pages, we present some highlights from a unique conference hosted by the Federal Reserve Bank of Cleveland in October 2013, as well as some very preliminary research we've conducted that suggests certain traits might make regional banks more successful.

Also in this issue is an article about the state of student loans and why the Federal Reserve and other policymakers might be wise to watch the trajectory of student loan debt carefully. We talked with experts on the subject at our annual Policy Summit, held in September 2013, and found no shortage of opinions on the way forward. Also from the Policy Summit, we sat down with Eldar Shafir, a behavioral scientist who was a keynote speaker at the conference, to discuss why people are really not rational in the way that economists like to think they are, and the practical significance of that difference.

Finally, I cannot end this message to our readers without a personal note about *Forefront's* editor in chief, Mark Sniderman. This is Mark's last issue, as he is retiring early this year after 37 years of distinguished service to the Federal Reserve. The Federal Reserve Bank of Cleveland as a whole and *Forefront* specifically have benefited immensely from his knowledge and guidance on monetary policy, financial stability, and community development issues. Please take the time to read Mark's farewell. And, as always, let us know what you think. ■

Survey Says Small Business Trends Are Positive but Concerns Remain



Access to credit and workforce issues are top of mind for small businesses.

The outlook for small businesses is improving, says a survey sponsored by the Cleveland Fed. The survey asked questions about the business conditions, financing, and workforce needs of small businesses. Fifty-five percent of respondents reported sales growth in 2013, and 78 percent expect sales to increase this year. More than a third of respondents added employees and almost half spent more on equipment and facilities in 2013 than in the previous 12 months.

Distributed through more than 20 partner organizations, including chambers of commerce and industry associations, the survey received responses from 143 businesses in the Fourth Federal Reserve District (Ohio, western Pennsylvania, eastern Kentucky, and the northern panhandle of West Virginia). Because of the relatively small sample size, the responses do not allow us to draw broad inferences, but they do provide a useful perspective on business conditions in the region and the challenges they pose.

With the positive results also came a number of challenges that could limit small business growth, including access to credit and finding the right workers. While 46 percent of respondents applied for credit in the past year, 14 percent reported that they did not apply for credit because they did not think their applications would be approved. For all credit products, 57 percent were approved for the full

amount sought and 22 percent for part of it. Credit approval rates were highest for new credit cards issued to businesses, though almost a third of applicants were approved for less than the full amount requested. The lowest approval rates were for applications to extend existing lines of credit. In 2014, a quarter of respondents plan to apply for credit; of those, 60 percent expect to secure it.

Workforce issues are also much on the minds of respondents, especially firms that need highly skilled workers. People with some of the most urgently needed workforce skills, including advanced computer and technology skills, are among the most difficult to find. Respondents also reported difficulty in filling positions that require advanced math and foreign language skills. Other challenges cited by respondents include weak sales and competition from larger businesses.

—Ann Marie Wiersch,
Senior Policy Analyst

Read more



For more details on the results of the 2013 small business survey, check out the full report at www.clevelandfed.org/research/data/small_business_survey/index.cfm

Can Limiting a 400-Year-Old Law Fix the Foreclosure Crisis?

Ways to expedite the foreclosure process for abandoned properties and to preserve homeowners' defenses in foreclosure actions are urgently needed. But the defects of the US home foreclosure system—poor communication, inconsistent requirements, foreclosure delays, devastated neighborhoods, and misaligned incentives—are standing firmly in the way, and it will take much imagination and stamina to push them aside. Maybe limiting the application of a 400-year-old law has the strength to push at least one of them.

The holder-in-due-course rule protects mortgage loan purchasers from liability for originators' wrongful conduct, such as lying about the terms of the loan. After the tsunami of mortgage foreclosures hit the Cleveland area in 2007, Cleveland Fed President Sandra Pianalto argued that laws responding to the home foreclosure crisis should align appropriate incentives with desired behaviors. Since that time, researchers at the Cleveland Fed have published their opinions on the issue, arguing that the ancient rule creates incentives for undesirable behaviors. The rule's protection led many loan purchasers to close their eyes to originators' actions because purchasers could collect loan payments, as stated in the paperwork, despite originators' misrepresentations.

A Cleveland Fed working paper advocated in 2008 for limiting the rule's application to home mortgage loans. Its authors still advocate that today.

Application of the rule had already been limited in consumer goods and services transactions, as well as high-cost mortgage transactions; action limiting its application to the entire home finance market is long overdue. Such action would prompt mortgage loan purchasers to police originators' behavior, because they would be legally responsible for originators' misconduct. Although this policing would probably entail a small cost increase, it would reduce the overall long-term cost of home mortgage loans to borrowers and lenders, make banks more attractive loan originators, and bolster the stability of the financial system.

The Uniform Law Commission (ULC), a group of state-government-appointed lawyers, judges, and legislators who work for the uniformity of state laws, formed a committee in 2012 to draft a uniform act for consideration by the states to improve the foreclosure system. After presenting a draft of the Home Foreclosure Procedures Act at the ULC's annual meeting in July 2013,

Researchers advocate for a unique tactic geared toward home mortgage foreclosure reform.

the commission voted to continue work on the uniform law, including the development of a proposal to limit the holder-in-due-course rule.

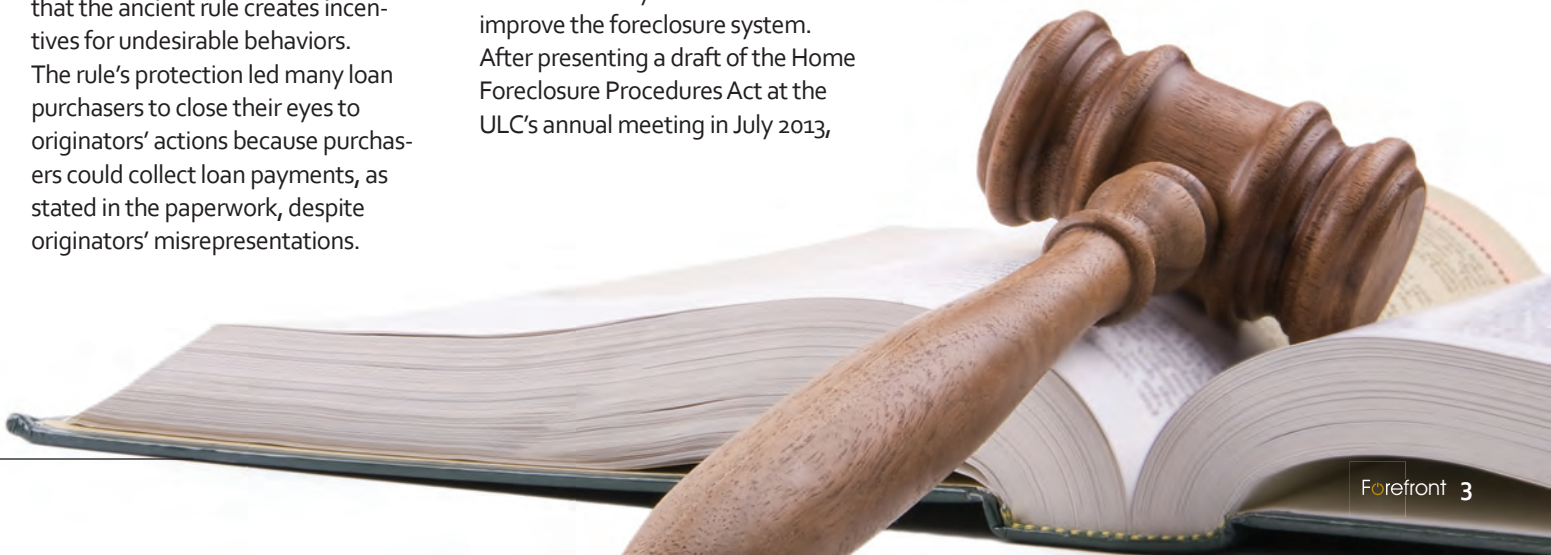
The committee will submit another draft at the 2014 annual meeting of the Commission on July 11–17. Whether they will adopt, reject, or defer action on the proposal remains to be seen. In the meantime, citizens' input and feedback is needed if the law is to achieve its objectives. The committee welcomes written remarks and encourages observers to speak at its meetings. ■

—Mark Greenlee,
Counsel



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Follow the work of the ULC at
<http://uniformlaws.org>



Focusing on the Future: Regional Banks and the Financial Marketplace



The Cleveland Fed zeroes in on regional banks, and shares preliminary results of its analysis of traits shared by those deemed healthy.

This article was written with contributions from the Cleveland Fed's Supervision and Regulation Department, including Lakshmi Balasubramanyan, Stacey Gallagher, Joseph Haubrich, Stephen Jenkins, and Nadine Wallman.

Of the approximately 6,300 banks across the country, just under 50 are considered regional. Individually, this type of bank doesn't seem to pose any more of a threat to financial stability than does a local grocery store. But there is strength in numbers, and failure in the aggregate could spell trouble. The financial crisis taught the Federal Reserve and other regulators many things, perhaps the most critical being that they had not focused enough on relationships and dependencies within the broad financial system. The focus had been narrow and concentrated on individual banks, and the cost was a breakdown of financial stability.

So now, even innocuous-appearing institutions like regional banking organizations, or RBOs, get extra scrutiny. On this topic, the Cleveland Federal Reserve hosted a one-of-a-kind conference in October 2013 where regional bank executives and board members from across the country, industry and market specialists, and Federal Reserve officials talked about the role of RBOs in the financial marketplace. In a world where too-big-to-fail banks know they face stepped-up standards, and where community banks know they are excused from the most rigorous new rules, regional banks still face some uncertainty about how they will be supervised. That is why the Cleveland Fed is making the effort to better understand them a priority—so that regional banks can get clarity about their regulatory environment sooner rather than later.

Why regional banks matter

In size, regional banks fall somewhere between the megabank and the bank that still might do business with a handshake. They are like the overlooked middle child, and partly as a consequence their role in the financial marketplace is not yet well understood. The Federal Reserve Bank of Cleveland defines RBOs as those with assets between \$10 and \$50 billion. Others define it differently, and some define them by what they are not (i.e., they're not too big to fail or community banks) but suffice it to say that these banks fall somewhere in the middle tier. This is not to say that they are all the same; within the class of banks known as RBOs, some are on the large size, some small; some focus on traditional banking products, others provide a much more complex array of products and services.

All banks, however, matter for financial stability, and regional banks are no exception. Following the recent financial crisis, the Dodd–Frank Wall Street Reform and Consumer Protection Act was enacted with the overarching goal of addressing the sources of the financial crisis—regulatory gaps and the shadow banking sector. The Cleveland Federal Reserve in particular adopted the practice of filling those regulatory gaps by adjusting the manner in which it supervises financial institutions. In it, banking organizations are assigned to tiers based upon their size, complexity, and riskiness.

The Cleveland Federal Reserve first talked about this approach in 2009, as discussions regarding regulatory reform were taking place. This type of approach is now reflected in the Dodd–Frank Act, under which larger organizations are subject to much stricter regulatory guidelines, supervision, and expectations than smaller organizations.

What the new approach means for RBOs is still being hammered out, but the Federal Reserve is already focusing on “right-sizing” supervision and not pushing down expectations from the larger organizations. At the same time, supervisory expectations for regional banks will continue to evolve. The challenge is to ensure that regulatory expectations and supervisory approaches within the regional banking tier remain reflective of the size, complexity, and riskiness of those organizations.

Knowing what it does about the regulatory environment that RBOs are faced with, the Cleveland Federal Reserve's approach to understanding this banking sector has focused on answering three questions. First, what impact do RBOs have on the regional economy? Second, what factors affect the health of these banks? Third, and most importantly, what role does this segment of banks play in financial stability?

Regional banks are regional drivers

RBOs are important drivers of growth in their local economies, but have been so only recently. In the 1980s, banks rarely had a truly regional reach, in part because they were allowed to open branches only in limited geographic regions, and rarely across state lines. In fact, it wasn't until 1994 that nationwide branching became feasible, albeit under certain restrictions and regulatory tests. But fast forward several years—think 2003 or so—and regional banks had become a recognized force in the industry. They generally grew by acquiring smaller banks or expanding into wider geographic territories, though exactly how they functioned wasn't necessarily well understood. Today, regional banks as defined by the Cleveland Federal Reserve, account for about 8 percent of the nation's banking assets.

Numerous studies, including those by Cleveland Fed researchers, have shown that local economic conditions also impact bank health. It's known that smaller regional banks, those closer to \$10 billion in assets, tend to be more affected by their local economies. For example, if the unemployment rate is high in a small regional bank's market, it will be reflected in its bottom line more than for larger regionals. The reason seems to be that smaller regionals are smaller in their geographic footprint, and perhaps narrower in their strategic focus, than larger regionals.

On the flip side, larger regionals are more sensitive to changes in the **yield curve**, and the wider the spread in yields, the healthier large regional banks tend to be. Larger regionals appear to be managing more activities involving interest-rate risk than their smaller counterparts, probably because of their greater sophistication or access to technology.

Yield curves track the relationship between interest rates and the maturity of US Treasury securities at a given time. Some look to the slope of the yield curve—the difference between the yields on short- and long-term maturity bonds—as a simple forecaster of economic growth. Generally, a flat curve indicates weak growth, and a steep curve indicates strong growth.

The Federal Reserve is already focusing on “right-sizing” supervision.



As the Cleveland Federal Reserve’s research progresses, RBOs’ impact on the regional economy should become even clearer.

What makes regional banks healthy

Knowing that RBOs affect their local economies on differing scales makes the Cleveland Federal Reserve’s second question—what makes regional banks healthy—even more relevant, as the health of the local economy depends partly on the health of their RBOs and vice versa. Our preliminary research, which was shared at the conference, shows that there may be some features common to both healthy regional banks and struggling ones in the new regulatory/supervisory environment since 2008.

More Banker Perspectives on Dodd–Frank

Bankers share concerns about complying with new mortgage rules effective January 2014.

Bankers representing financial institutions of all sizes joined the Cleveland Fed at its 2013 Policy Summit on Housing, Human Capital, and Inequality, held in September, to share their knowledge and views with researchers, policymakers, and other bankers. In a special banker track, participants discussed the impact of the Dodd–Frank Act in terms of compliance, specifically on qualified mortgages and qualified residential mortgages (QMs and QRMs).

The bankers on the panel and members of the audience agreed that the Act, particularly the mortgage origination and servicing provisions that became effective in January 2014, will have significant, long-lasting effects on financial institutions of all sizes. Common themes were the possible, but unintended, consequences of Dodd–Frank, the direct and indirect costs of compliance with the Act, and the importance of having the right technology and operations for implementing it.

Bankers are concerned that qualified mortgage rules could limit available credit. Without legal protections for qualified mortgages, lenders’ hesitation to offer other types of mortgages could limit flexibility and discourage innovation. They feel that this could have a significant effect on lower-income borrowers. The 43 percent debt-to-income ratio and the points and fees limits, especially for smaller loans, could make it harder for lower-income borrowers to qualify. Further, bankers are concerned that excluding interest-only and, for some lenders, balloon loans, as qualified mortgages could hamper loans to borrowers who have had financial difficulties.

Both bankers and presenters discussed the potential of fair lending and Community Reinvestment Act



QUALIFIED MORTGAGES are a new class of mortgages in effect as of January 10, 2014, for which borrowers who qualify are presumed to be able to repay.



QUALIFIED RESIDENTIAL MORTGAGES are similar to QMs, with an added component of being exempt from risk retention. The rule is still being finalized.

What classifies a bank as healthy, for the purposes of this analysis, comes from using a bank-rating system called CAMELS. Under this system, the following components are assessed:

- (C) Capital adequacy
- (A) Asset quality
- (M) Management
- (E) Earnings
- (L) Liquidity
- (S) Sensitivity to market risk

These ratings combine financial measures with safety and soundness measures, and include both data and elements of supervisory expertise. CAMELS can deliver a clearer picture than most other individual measures, even though other metrics are undoubtedly useful. For this analysis, a high score on the CAMELS rating system equals a healthy bank.

Healthy regional banks shared both a high return on assets and a heavier reliance on "hot" money such as time deposits and brokered deposits. A high return on assets seems a given, but one might assume that large concentrations of hot money wouldn't describe strong banks. But the preliminary analysis suggests that it can be a sign that banks had such good lending opportunities that the market readily supplied them with hot funds. To be sure, hot money can be risky when it creates a maturity mismatch, and a bank with a lot of mismatched maturities on its balance sheet would probably not be considered healthy.

Hot money refers to investment funds intended for the highest short-term rate of return.

(CRA) performance. The director of the Consumer Financial Protection Bureau, Richard Cordray, has stated that institutions already engaged in responsible lending practices and aware of fair-lending concerns should not be materially affected by the changes. However, presenters pointed out that financial institutions should maintain rigorous fair-lending assessments, testing, and processes to help identify and address potential risks. For the CRA, the presenters stressed the importance of monitoring mortgage lending to determine whether its volume declines significantly because of qualified mortgages, especially for low- and moderate-income areas and borrowers.

The costs of implementing the entire Dodd–Frank Act, bankers agreed, are immense. Some are relatively transparent, including those associated with hiring more staff and changing or implementing systems. Other costs are harder to quantify, such as resources that need to be directed to compliance and could have been used elsewhere.

Bankers stated that there is no easy way to measure the additional cost associated with complying with the law. One banker on the panel stated that larger banks may have an advantage in implementing these changes because they can spread out the costs to achieve economies of scale, but all bankers indicated that the cost of Dodd–Frank, whatever the size of the institution, is significant.

The importance of technological and operational initiatives that have been or will be established to support the regulatory consequences of the Dodd–Frank Act was another hot topic. All three of the institutions represented on the banker panel—PNC, FirstMerit, and First Federal Community Bank—have made changes to accommodate the law and noted that employees have been added and some responsibilities have been shifted to implement the regulatory changes. One of the panel members also discussed the importance of testing and quality

control/assurance activities, especially after the changes have become effective. Other technology initiatives to support the changes brought about by Dodd–Frank include multiple system modifications to identify qualified mortgages and to generate proper disclosures, along with reporting and tracking to help ensure compliance with the rules.

Although the bankers acknowledged the hurdles associated with Dodd–Frank, including the time needed to understand the rules and the resources required to implement them, there was a general agreement that the changes are needed to address some of the issues that came out of the housing crisis. Several participants pointed out that the true costs of the law will not be apparent for several years. Stay tuned. ■

—Kelley Richards,
Senior Examiner

A particularly noteworthy conclusion of the analysis focused on something else the healthiest banks shared: higher expense ratios.

As for traits shared among not-as-healthy RBOs, the preliminary research showed that these banks' portfolios had high concentrations of commercial real estate. They also tended to be located in states hit hardest by the crisis and recession, particularly where home prices crashed the most, and in states with unemployment rates greater than 10.5 percent.

A particularly noteworthy conclusion of the analysis, however, focused on something else the healthiest banks shared: higher expense ratios. This might seem counter-intuitive, but one possible implication of a higher expense ratio may simply be that a bank is spending wisely on quality employees and systems—that's why they achieved higher safety and soundness ratings. Runaway spending, of course, is probably not a recipe for success.

The preliminary results of this analysis into what has made regional banks successful since 2008 are, of course, just that—preliminary. Other explanations will be explored, other avenues considered. For now, the point is that the Cleveland Fed knows what success looks like; why and how requires more analysis.

Financial stability

The Federal Reserve's work when it comes to fully understanding regional banks' role in financial stability is, for all intents and purposes, still in an exploratory stage. Much progress has been made; however, to ensure that financial institutions—regardless of their size—have sufficient capital to absorb losses and support operations during times of adverse economic conditions, a key component in support of financial stability.

Take the **Comprehensive Capital Analysis and Review (CCAR)** process, for example, now in its fourth year. Throughout the rule-writing process for the Dodd–Frank Act's Stress Test and the work for clarifying examiner expectations,

The **CCAR** is an annual exercise by the Federal Reserve to ensure that institutions have robust, forward-looking capital planning processes that account for their unique risks and sufficient capital to continue operations throughout times of economic and financial stress.

regulators such as the Federal Reserve, Office of the Comptroller of the Currency, and the FDIC have been working together to ensure clear standards are set that are appropriately tailored for the size and complexity of these firms. The burden of compliance with the CCAR falls on companies with more than \$50 billion in assets—the largest banking institutions that by size alone can be thought of as systemically important.

By comparison, regional banks will be conducting their own reviews annually and reporting the results to their regulator, with the first cycle to begin March 31. These company-run reviews are less burdensome and less complex than the Federal Reserve–run reviews. That reflects the spirit of the Cleveland Federal Reserve's tailored approach—different tiers mean different expectations. This helps level the competitive playing field both between and within classes of banks while ensuring all companies have sufficient capital to weather an economic storm.

How regional banks can help themselves

In addition to the Federal Reserve's focus on ensuring that its supervisory approaches evolve with the size and complexity of the firms it supervises, RBOs themselves have realized the need to strengthen their own control and oversight functions. One such area, which has evolved considerably over the past several financial crises, is enterprise risk management (ERM).

A leading topic of discussion at the Cleveland Federal Reserve's RBO conference, ERM has become a critical component for financial institution's boards of directors and executive management teams to ensure that risks throughout their organizations are appropriately measured, monitored, and controlled. As testimony to how critical ERM has become to financial institutions, one attendee stressed that their company strives to stay on the leading edge of ERM. Examples of leading practices discussed by conference attendees include board of directors' establishing formal risk appetites, risk management evolving from a control function to becoming something that is owned by all employees within the organization, and the presence of a credible challenge process among all levels of the organization.

In addition, financial institutions are recognizing the need to incorporate more forward-looking parameters in their measurement of risks as a means to better prepare for the uncertainty of the future. As a result, stress testing has become an increasingly important ERM component and therefore an important tool enabling boards of directors to effectively measure, monitor, and report the risks of their institutions. Dodd–Frank added the expectation for regional banks to conduct company-run stress tests; however, as one conference attendee stated, such stress tests should be considered a staple risk management tool and not be viewed as a regulatory exercise.

Focusing on the future

While all bankers at the conference seemed to agree that the regulatory compliance environment can be onerous, they also agreed that to succeed they need to be best in class in all areas of regulatory focus. But that's where agreement became less clear for the regional bankers.

Finding and retaining qualified staff, for example, is always a challenge, but it's even more so when you're looking for workers whose skill sets are in high demand, such as quantitative analysts and modeling experts. A common strategy among RBOs has been to outsource model development, which is expensive, and the banks need to continually perform gap analysis to determine if it is better to spend internally or externally. It's also difficult to determine how much money to spend on risk management functions.

Achieving economies of scale was an underlying theme discussed by conference participants. Some regional banks report trying to be aggressive in their organic growth, but not all bankers think that will be successful in the long term. Others say that over the next few years, as happened in the 1990s, the greatest opportunity for RBO growth will be through acquisitions. Others think more philosophically: It is during the most challenging times that industry leaders pull away from the pack by capitalizing on opportunities.

In the banking world, many community banks focus mainly on service, megabanks on scope, online financial institutions on price. RBOs can offer it all, even under incredible pricing pressures. Because they focus on a particular region, RBOs also have the advantage of knowing their customers more intimately, allowing most to offer a specialized product or a more tailored customer experience. One banker at the Cleveland Federal Reserve's conference suggested that this hybrid strategy is one way forward-looking RBOs might differentiate themselves.

The next steps in the Federal Reserve Bank of Cleveland's effort are to extend and refine its preliminary analysis of what makes RBOs healthy. The Bank's researchers will also be looking to build upon their understanding of the role these financial institutions play in the regional economy and their impact on financial stability. ■



Read more

Get the Cleveland Fed's detailed analysis in "What Do We Know about Regional Banks? An Exploratory Analysis" at www.clevelandfed.org/research/workpaper/2013/wp1316.pdf

See our proposal for a framework for systemically important institutions at www.clevelandfed.org/forefront/article.cfm?a=10026

Learn more about QMs and QRMs at www.clevelandfed.org/community_development/events/ps2013/pres_a5_benton_bell_6c.pdf

The Cost of College: Student Loan Debt on the Rise

Substantial growth in student loan debt prompts policymakers to keep a watchful eye.



Ann Marie Weirsch
Senior Policy Analyst

Three facts about student loan debt:

1. Total student loan debt outstanding has quadrupled since 2003.
2. Student debt now exceeds all other forms of consumer debt—even credit cards.
3. Student debt has the highest delinquency rate of any consumer loan category.

Is this something that warrants the attention of Federal Reserve policymakers? In light of the Fed's responsibility for promoting the health of the financial system and the economy, the answer is a tentative yes. Nearly all experts agree that the returns on graduating from college still far

outweigh the cost, and the good news is that enrollment remains strong. In fact, the Federal Reserve Bank of Cleveland has been emphasizing for many years that education is the key to success for both individuals and regions. For individuals, the benefits of education are straightforward: higher pay and better job prospects. For regions, an overwhelming amount of research, including extensive work done at the Cleveland Fed, demonstrates the importance of educational attainment in helping cities grow and thrive. Our research has shown that education is one of the two most important drivers of regional income growth (innovation is the other).

While it's clear that educational attainment is a crucial factor in economic growth, the debt associated with it can have some limiting effects. The implications of student loan debt reach beyond the borrowers themselves and can have a dampening effect on overall economic growth. This means that policymakers would be wise to watch the trajectory of student debt carefully, be mindful of its longer-term implications, and consider policy alternatives that can minimize its drag on the economy.

Student debt is growing, but there is no crisis

The Consumer Financial Protection Bureau (CFPB) estimates that student loans outstanding total around \$1.2 trillion, spread among 40 million borrowers, or an average debt of nearly \$30,000 per student. Other statistics put the median student debt at close to \$14,000. Being \$30,000 (or even \$14,000) in debt is certainly significant for borrowers. But looking at it another way, these figures are comparable to auto loans, which borrowers have been managing quite well over time. Of course, \$30,000 is the average: The range of debt burden varies tremendously from student to student, though many of the graduates with the heaviest debt burden land high-income professional jobs—doctors or attorneys, for example—that put them in a strong position to repay the debt.

Trends to watch

Although college is a good investment for students and society at large, and it appears to be cost effective for the government for now, there are some issues policymakers might want to keep an eye on. First and foremost, student loan debt is growing rapidly and has doubled since 2007. Experts point to the aftermath of the recession, rather than rising college tuition, as the primary driver. As parents have been less able to cover the costs of educating their children, increasing numbers of students have turned to loans for financing.

According to Pew Research, 19 percent of US households had student loan debt as of 2010, and 68 percent of 2012 grads left school with more than just a diploma. Not surprisingly, such debt is more prevalent among younger households: 40 percent of those headed by someone younger than 35 carry student loan debt.

Another trend to watch is the rise in delinquency and default rates on student loans. Nearly 17 percent of borrowers in repayment are delinquent; other adjusted calculations put the share closer to 23 percent. Student debt has the highest delinquency rate of any consumer loan category; by some estimates, \$100 billion in debt is now delinquent 90 or more days.

Policymakers would be wise to watch the trajectory of student debt carefully, be mindful of its longer-term implications, and consider policy alternatives that can minimize its drag on the economy.

Experts believe that a majority of student loan defaults are concentrated among those who did not complete their education; their default rates are four times higher than those of graduates. This is not surprising, since many of these dropouts, unlike graduates, are no better able to repay than they were before enrolling. The problem is exacerbated by high dropout rates at for-profit institutions, where nearly 90 percent of students take out loans. In addition, completion rates may be declining at all institutions under the stress caused by student loan debt. An Ohio survey reveals that 22 percent of four-year public college students occasionally consider dropping out because of finances, and 9 percent think about it frequently. These statistics are even higher among students of four-year private schools and two-year schools.

Relatedly, since much of the nation's student loan debt is directly loaned or backed by the federal government through various programs, taxpayers still bear some risk, even though the programs are currently operating in the black. However, if default rates were to rise further or if an aggressive policy change such as debt forgiveness came into play, taxpayers could be on the hook.

It's important to note that the student debt burden lies not only with the students, but also with their families. Parents and grandparents often co-sign for these loans and may be saddled with costly repayment when they are retired or trying to save for retirement. According to the Federal Reserve Bank of New York, people who are 60 or older owe \$43 billion in student debt. Of course, co-signers' ability to make payments does not improve because of increases in the students' educational attainment.

19 percent of US households had student loan debt as of 2010, and 68 percent of 2012 grads left school with more than just a diploma.

Economic impact

In the larger economic picture, the effects of mounting financial obligations associated with student loans go beyond student borrowers and their families. The drag on economic growth is becoming more evident as debt levels rise, and the effects are likely to be felt far into the future.

As recent graduates settle into the workforce, they often grapple with sizable payments on their student loan debt. A report from the CFPB suggests that the burden of student loans is a factor in the significantly lower 401(k) enrollment and contribution rates among those under 30. Because of the importance of early saving, borrowers who allocate income to student loan payments rather than to retirement significantly reduce the final value of their retirement savings.

In a more immediate sense, student borrowers face financial barriers to reaching the milestones of early adulthood. Statistics indicate that household formation rates are down by wide margins since the onset of the recession. Financial obligations associated with student debt decrease borrowers' ability to take on additional expenses, making them less likely to move out of their parents' homes and creating a drag on household formation. Moody's estimates that each new household formed creates \$145,000 in economic impact. Furthermore, borrowers are less able to save for down payments on a home, to qualify for mortgage loans, or to be approved for other consumer loans, including auto financing. The National Association of Realtors reports that 77 percent of respondents to a 2013 survey described student debt as an obstacle to homeownership, and 49 percent called it a "huge" obstacle. With so many young adults saddled with sizable student loans, industry experts observe that the presence of first-time home buyers is declining and the ripple effects are visible throughout the housing market.

Student loan debt may also prevent recent college graduates with an entrepreneurial spirit from starting a new business or expanding an existing one. It can also limit small business owners' ability to qualify for loans, preventing growth and payroll expansion. Finally, student loan debt may affect young professionals' career choices. For example, doctors may avoid low-paying but much-needed specialties, such as caring for the elderly or for children. Talented teachers may leave their profession in search of higher-paying careers in order to offset the impact of student loan payments on their personal finances. Thus, at least in terms of career choice, the social costs of college debt are likely to grow as debt levels rise.

Proposed policy alternatives

The Federal Reserve Bank of Cleveland's 2013 Policy Summit on Housing, Human Capital, and Inequality, held in September, featured two sessions on the subject of student loans. Academics and practitioners shared their research findings and observations with participants and led active discussions on policy considerations. While none of these proposals is a solution in itself, they might help bring about a less-indebted generation of students, while minimizing negative consequences to educational attainment.

Education, education, education

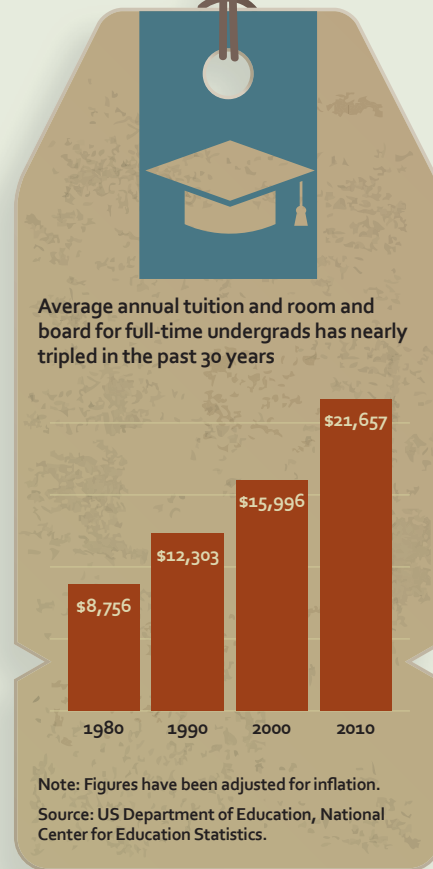
One thing we heard over and over is that apart from being educated in their chosen fields, students should be educated about borrowing for college. Experts have proposed providing resources and counseling to students to give them an accurate perception of the debt they are taking on, the future costs, and the long-term value of their education. "You'd be amazed at how many people come into my office every day and say 'I borrowed \$30,000. I have a 10-year repayment. I'll repay \$3,000 a year, and we're cool.'" says Bryan Ashton, senior program coordinator at Ohio State's Student Wellness Center. "The concept of interest isn't there." Helping students anticipate their future financial situations in the short term could go a long way. But being proactive needs to start even earlier: Financial education in K-12 is crucial because by the time students are on the college campus, it may be too late despite every good intention.

College by the (Rising) Numbers

For students, the price tag of a four-year college education is close to triple what it was three decades ago. While many have pointed to rising costs at schools themselves—especially higher administrative expenses and construction outlays—there are other important factors driving tuition rates higher. Practitioners at the Federal Reserve Bank of Cleveland’s Policy Summit weighed in with their perspectives on the rising cost of getting a degree.

A primary driver of tuition prices is the change in who is footing the bill, said Justin Draeger, CEO of the National Association of Student Financial Aid Administration. In the 1980s, federal and state government funding covered more than 75 percent of the cost of education. That figure has fallen to just over 50 percent and continues to trend downward. In fact, the New York Fed reports that public funding, driven by lower state appropriations, has fallen every year since 2000. The reduction in education funding became even more pronounced during the recession, which hit state governments hard. Nearly two-thirds of states cut their higher education budgets by more than 25 percent in the years following the onset of the recession. With the decline in government support, families are left to make up the difference, as they pay an increasing share of the total cost through higher tuition bills. Thus, as Scott Karol, director of program evaluation and technology at Clarifi, pointed out, students must carefully consider the return on their investment as college degrees become increasingly expensive.

Tuition prices are often gauged relative to other prices, and in recent years, college costs have risen much more quickly than inflation. Draeger explained that the productivity gains seen in other industries (which help to drive costs and prices down) are difficult to achieve in the college setting. Schools can’t simply educate more students with fewer teachers without sacrificing quality.



Bryan Ashton, senior program coordinator at Ohio State’s Student Wellness Center, added that schools will need to be creative and open-minded as they explore ways to manage their costs and control tuition growth.

Finally, students can affect their own cost of education through their borrowing decisions. Federal loan standards allow students to borrow the full cost of attendance and incidentals. As Ashton explained, some students borrow the maximum amount allowed semester after semester (whether they need it or not) and spend the surplus on expensive rentals and other extras that drive their own education-related costs higher. Financial counseling can be instrumental in helping students to understand the real future cost of their decisions.

Some experts assert that there isn't a student loan debt crisis per se as much as a student loan repayment crisis.

Educating students on the potential return on investment associated with their degree choices is another approach that experts think will minimize future financial strain. According to Scott Karol, director of program evaluation and technology at Clarifi, a non-profit community resource devoted to lifelong financial literacy, incoming students need to make purposeful degree choices with the resulting financial picture in mind. While Karol stressed that the value of a college degree is definitely worth it, he also suggested striking a balance between the cost of the degree and the associated earning potential. If, for example, you apply to several schools to earn a certain degree and “take on four times the amount of debt load [at a very prestigious school] as would be necessary to get the same degree at a more inexpensive university, was that a smart decision?”

Also a topic of discussion was the potential for removing subsidies entirely or withholding loans for certain degrees and fields of study. While none of the presenters advocated such a drastic measure, associate professor at Seton Hall University School of Law Michael Simkovic did propose that interest rates on student loans should reflect the value of various degrees in the workforce. Under this system, for example, science, technology, engineering, and mathematics (STEM) degrees would feature low interest rates, while liberal arts students would pay higher rates on their loans.

Students should also be aware of the factors that increase the likelihood that they will complete their education. For instance, statistics show that dropout rates are higher for students who live at home with parents or who hold off-campus jobs. Furthermore, by encouraging students to complete college in fewer semesters, schools can increase graduation rates and enable students to finish with less debt. Since the outcomes of their decisions aren't always intuitive, the more schools and agencies can educate students, the better. A student may feel inclined to work extra hours during the school year to offset their tuition costs, but according to Ashton, that decision might not make financial sense if it causes the student to take a lighter course load and incur a semester or two of additional debt.

All practitioner experts at the Policy Summit — Ashton, Karol, and president and CEO of the National Association of Student Financial Aid Administration Justin Draeger — recommended taking steps to incentivize schools to promote timely graduation and to reduce overall borrowing by minimizing the number of semesters. Also, students who might benefit from alternative paths should consider them, including the completion of early courses at community colleges at a substantially lower cost.

Finally, while the CFPB has taken steps to address some issues related to for-profit schools and the disproportionately high levels of debt and default associated with them, the recommendations have not been fully implemented and do not adequately tackle the problem. Before deciding whether to enroll at for-profit colleges, students should consider several factors, such as the relative costs of the programs, the economic value of the degrees and certificates they offer, average completion rates, and the limitations on transferring credits among schools.

Borrowing and repayment alternatives

Both the academic and practitioner experts gathered at the Policy Summit agreed that more can be done to ensure suitable loan repayment options for students. In fact, both academic Daniel Kreisman, postdoctoral research fellow at the Gerald R. Ford School of Public Policy at the University of Michigan and practitioner Draeger assert that there isn't a student loan debt crisis per se as much as a student loan repayment crisis, "especially for those who may not have been prepared for college, took out loans, and then didn't complete their educations," says Draeger.

Although alternatives beyond the standard 10-year repayment schedule are available, most students are unaware of these programs and accept the default option without careful consideration. Several presenters recommended broadening the repayment alternatives, including discharge of debt through bankruptcy in limited instances.

Additional suggestions addressed borrowers' ability to repay, with the goal of reducing the future risk of non-payment. Structuring repayment schedules to account for income levels and growth in income over time may enable borrowers to shift the repayment burden to later in their careers when they are more financially settled and in a better position to make payments. Alternatively, a longer standard repayment period would lower payments and enable debtors to weather periods of job loss or reduced income.

To implement income-sensitive repayment schedules, Kreisman suggested a partnership with the IRS to track income levels, adjust payments accordingly, and authorize automatic withholding. Practices utilized by the Social Security Administration would be helpful in shaping such a program.

Interest rates that better account for the cost of lending would benefit some borrowers a great deal, according to Kreisman. Since interest rates on student loans are locked in at the time of graduation, students may face a much heavier debt burden if they graduate during a less favorable interest rate period. Because this debt cannot be refinanced, students have few options for addressing the associated costs at a later time.

Presenters also suggested that private student loans should have the same level of consumer protection as other types of consumer debt. Private student loans make up roughly 14 percent of outstanding student debt, and servicing these loans is associated with many complaints, according to the CFPB.

Finally, several of the experts addressed the issue of underwriting standards and whether ability to repay was a fair consideration in awarding student loans. They agreed that steps should be taken to consider the debt burden associated with repayment and a borrower's future ability to repay, though the focus must remain on making loans available to students who need them.

Keeping a watchful eye

As students continue to graduate (or not) into a tough job market, there are opportunities to shed light on some crucial aspects of student loan debt. Talks with the experts will continue, as will research into how the economy can continue to benefit from its citizens' educational attainment while at the same time managing their debt. With Cleveland Fed research clearly showing the link between educational attainment and economic prosperity, it's only right to do so. ■



Read more

Learn more about how education affects economies in *Altered States: A Perspective on 75 Years of State Income Growth* at www.clevelandfed.org/about_us/annual_report/2005

For videos, presentations, and more from the 2013 Policy Summit on Housing, Human Capital, and Inequality, visit www.clevelandfed.org/community_development/events/ps2013

Streamlining the System of Workforce Development



Ericka Thoms
Policy Analyst

Worker training is not keeping pace with employers' needs, though it's not for lack of effort. In fact, almost 50 workforce development programs are run out of Washington, DC, alone. Yet, despite the number of programs, a skills gap caused in part by a workforce untrained for the new economy has left many regions with the strange combination of a lot of open jobs and a lot of people still looking for work. Frustrated policymakers have struggled to come to an agreement on the right approach to filling the skills gap and funding programs appropriately. What is widely agreed on, however, is the need for increased efficiency in the workforce development system to better match the unemployed with the jobs available.

With multiple funding streams and the diverse needs of those looking for work and training, the national workforce development system has become more of a patchwork than a system. A lack of collaboration and communication among stakeholders has led to many programs being designed to meet specific needs without knowledge of or research into existing programs that may already offer what is needed. A 2011 report by the Government Accountability Office identified nine federal departments that run a total of 47 workforce development programs. Of the 47 programs, 44 offered services that overlapped with at least one other program.

Funding itself, too, is an issue. Funds come from federal, state, and private sources, with the majority of federal funds coming through the Workforce Investment Act (WIA). Despite a brief injection of stimulus funds under the American Recovery and Reinvestment Act in 2009, federal funding for workforce development has been steadily

Conversations between regional workforce development stakeholders and the Federal Reserve show the need for efficiencies similar to those at the national level.

declining since 2001. This is due in large part to Congress' inaction on reauthorizing WIA. Proposals have been made in both houses, but there is little movement on crafting a final bill. Since expiring in 2003, WIA's program has been funded through annual continuing resolutions, but the amount budgeted has not increased since the original legislation. WIA, as it happens, was supposed to serve as the "one-stop" delivery service for adult education and literacy services, the employment service, and vocational rehabilitation services for individuals with disabilities.

With tightening federal resources, workforce training programs are being asked to do more with less. As such, there is heightened interest in the structure of the national workforce development system. The redundancies in the system, paired with the push for deficit reduction, have drawn attention from legislators looking for cost savings and greater efficiency in government services.

To that end, in 2013 Senator Rob Portman (R-OH) introduced the CAREER (Careers through Responsive, Efficient, and Effective Retraining) Act with Senator Michael Bennet (D-CO). Among other things, the bill requires the Administration to create a plan for "decreasing the number of federal job training programs without decreasing services or accessibility to services by eligible training departments." Portman's legislation has supporters from a wide range of stakeholders, including educators, workforce development agencies, businesses, and advocacy organizations, all of which have offered public statements in favor of the bill. Currently the bill is in the Senate Committee on Health, Education, Labor, and Pensions, where the committee chair will decide if it moves forward.

Similar calls for efficiencies were heard at structured “listening sessions” convened by the Federal Reserve Banks of Cleveland and Philadelphia to discuss workforce development for workers ages 16–24. Talking with stakeholders in five Pennsylvania cities, Fed staff heard several themes consistent with concerns at the federal level. Listening-session participants, including educators, chambers of commerce, and community foundations, spoke of the need for greater collaboration, better dispersion of funds, more information on available programs, and greater flexibility in implementing programs.

A familiar theme, frequently touched on by participants, was the disconnect among the numerous workforce development programs. Like federal programs, local and regional programs are often not aware of each other, leading to unnecessary duplication of services, not to mention confusion for clients. Progress is being made, though, and collaboration among agencies has increased recently. For example, in Harrisburg, Pennsylvania, the Education and Business Partnership Committee, a collaboration between the Harrisburg Regional Chamber and the Capital Region Economic Development Corporation, guides students as they enter the workforce and retrains unemployed workers.

While decreases in funding have prompted some programs to share resources and work more collaboratively, working with tighter budgets is always difficult. For instance, smaller cities and rural areas noted that they find it difficult to develop workforce programs because they feel their piece of the pie takes the biggest hit when funds decrease. Stakeholders in these areas say that, because their programs serve relatively few people across a large geographic area, making a case for more funds is challenging when larger cities have documented greater populations in need. Another example: Subsidy-dependent programs tend to operate for only a short time, minimizing their effectiveness and cutting the number of people served. Programs that were funded for a few years and then discontinued include a Job Corps program in Erie that provided training and subsidized youth employment and a YouthBuild program in Harrisburg.

Conversation with stakeholders also highlighted the need for better communication about existing services to both those looking for training and those looking to hire. In Erie, for example, participants spoke about the need to increase awareness of programs among employers in order to serve more people and improve training experiences.

Federal workforce development funding has steadily decreased*



Better communication with high school teachers is also needed because they have had to serve as career advisors as well as teachers in the wake of guidance counselor cuts.

Finally, federal programs’ sometimes-narrow focus often hampers them. Many have very specific demographic requirements that participants must meet. Income, ethnicity, location, age, and a variety of other indicators can determine eligibility for training and assistance programs. Added to that is still the lack of a holistic perspective on workforce development, which would consider the collateral needs of trainees. The fact that potential participants are seeking help in finding work indicates that they likely have tight budgets. As a result, clients may have a variety of collateral needs, such as child care and transportation, that directly impact their success in any program.

The workforce development system—nationally, regionally, and locally—faces difficult challenges. The patchwork system that currently exists would likely benefit from a variety of administrative efficiencies and other cost-saving measures along the lines of those being discussed at the federal level. Building the political will at all levels could prove the more difficult task. ■

Read more



For more on the listening sessions described in this story and other workforce development research, visit www.clevelandfed.org/Community_Development



Forefront talks to the Cleveland Fed's Jean Burson about the financial troubles in the US Commonwealth.

Will Puerto Rico Default?

Moody's recently reported that markets are treating Puerto Rico as having a more than 15 percent chance of defaulting on their financial obligations in the next five years. With only enough assets to cover 8 percent of its public pension liabilities, this US Commonwealth finds itself in a bind. In January, *Forefront* talked with Jean Burson, a Cleveland Fed policy advisor and expert on public pensions to learn more about the financial troubles in Puerto Rico, and what they could mean for the US financial system.

Forefront: *First things first: What is going on with Puerto Rico's finances?*

Burson: Puerto Rico is a very important player in the municipal bond market, and investors have begun to question whether the Commonwealth will be able to honor its nearly \$55 billion in outstanding net tax-supported debt. It has the highest level of per capita debt outstanding when compared with the 50 states, and most of that debt is not insured. In addition, it has been in recession for seven years, has experienced significant population loss, and has \$37 billion in unfunded public pension liabilities, which results in a situation where the funds have only enough assets to cover about 8 percent of their liabilities.

Forefront: *Who owns this debt?*

Burson: Puerto Rico's debt is widely held, since it pays a significant premium over other investment-grade debt and it's exempt from federal, state, and local taxes. In fact, some investors are only now becoming aware that they are holding Puerto Rico's debt. For example, an Ohio investor seeking exemption from federal and state taxes might choose to invest in a single state (Ohio) fund. But that single state fund might also include Puerto Rico's bonds, since they are also exempt from federal and state taxes, and the investor might not be aware that these bonds have been included.



Forefront: *Do Puerto Rico's debt troubles pose a risk to the US or world economy?*

Burson: The municipal bond market is very resilient due in part to its diversity, and most of the recent headlines—including the announcement of Detroit's bankruptcy—have been met with measured market reaction. Puerto Rico's fiscal challenges are well known to investors, but renewed attention in the context of significant market outflows that began over the summer has driven yields on the Commonwealth's general obligation debt to a spread of nearly 700 basis points over US Treasuries. This reaction is rooted in concerns about a possible downgrade to below investment grade or even a default. In fact, of all of the states and sovereigns rated by Moody's, only Argentina is seen as more likely to default.

The bottom line, though, is that the municipal bond market is very diverse. While a default by Puerto Rico could certainly impact some financial institutions, we don't believe it presents a significant risk to the financial system as a whole. Our concerns are further lessened by the fact that most municipal debt is held by high-net-worth households and mutual bond funds, which are not highly leveraged and act as a buffer.

Forefront: *It sounds as if the risks to the financial system are somewhat managed, but what about the risks to Puerto Rico?*

Burson: Puerto Rico is struggling to emerge from recession. A downgrade would put additional financial strain on the Commonwealth, as it could lead to a requirement to post as much as \$1 billion in collateral on financing transactions already in place. Negative headlines are prompting banks to become increasingly cautious in providing short-term liquidity, which makes the situation increasingly precarious.

One of the things that makes the Puerto Rico issue so noteworthy is that the federal bankruptcy code treats the Commonwealth as a state, and so it cannot file for protection under Chapter 9 bankruptcy. As a result, the Commonwealth has no mechanism to restructure its debts or modify its contracts.

Forefront: *Is there hope for improving Puerto Rico's situation?*

Burson: The news coming out of Puerto Rico is not all bad. The newly elected governor raised the income tax, implemented new taxes, and enacted comprehensive public pension reforms that are projected to contain costs over time. Unless the debt is downgraded, which could lead to a requirement to post collateral on existing financial arrangements, liquidity does not appear to be a concern for the remainder of 2014. And while debt levels relative to the size of Puerto Rico's economy are certainly higher than in any of the 50 states, they are actually quite modest when compared with some other countries.

Investors have begun to question whether the Commonwealth will be able to honor its nearly \$55 billion in outstanding net tax-supported debt.

Forefront: *Where does the Federal Reserve fit in to situations such as these?*

Burson: The Fed's efforts to promote economic growth and maintain price stability provide the necessary environment for Puerto Rico to emerge from recession and transition to a more stable fiscal path. Meanwhile, the Federal Reserve Bank of Cleveland has a dedicated team in place to monitor any potential threats coming from state and local government finance, including public pensions and the municipal bond market. We continue to follow developments in Puerto Rico and troubled municipalities carefully and share our insights with our colleagues at the Board of Governors of the Federal Reserve System and others in the System. ■

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Download papers and presentations from the Cleveland Fed's 2013 Conference on Public Pension Underfunding at www.clevelandfed.org/events/2013/pensions

Anchors and Arts Help Redefine the Rust Belt



Mary Helen Petrus
Outreach Manager
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“Rust Belt” is a term with a positive spin for those who embrace the hardscrabble authenticity of older industrial cities. After all, they say, there’s a certain cachet to Rust Belt chic. For others, the label makes for bad public relations. Think disinvestment, decreasing population, job loss — the downward trends that have occurred in many cities over the past 20 years. To survive, much less thrive, Rust Belt cities have had to devise ways to turn the tide and revitalize, to reach for the chic. How can these cities attract and retain residents, encourage investment, and foster asset creation and innovation? Sharing strategies and successes among like cities is a start.

In October 2013, the Cleveland Fed hosted the second part of a videoconference series aimed at connecting local policymakers, community organizations, and civic and community leaders in four Rust Belt cities.

An innovative videoconference series helps Rust Belt cities share strategies and successes to help them thrive.

“Redefining Rustbelt: An Exchange of Strategies by the Cities of Baltimore, Cleveland, Detroit, and Philadelphia” is sponsored and hosted by the Federal Reserve Banks in whose regions the cities reside.

Inspired by Baltimore Mayor Stephanie Rawlings Blake’s initiative to increase Baltimore’s population by a net 10,000 families by 2020, the videoconference series has sparked much conversation — and some debate — over the best ways to innovate into the future. One thing all participants agree on, however, is that it has to happen, and fast.

Anchor institutions

At the first conference, in Baltimore, participants suggested that the economic and community development package for Rust Belt cities needs to be comprehensive. That means focusing on things like racial and economic integration, reforming our public education systems, leveraging anchor-institution strategies, and implementing place-based strategies that attract artists and others who can strengthen downtowns and neighborhoods.

These last two—leveraging anchor institutions and the arts for community and economic development—served as the focus of the October event initiated in Cleveland. Mark Sniderman, executive vice president and chief policy officer of the Cleveland Fed, kicked it off with a question with no clear answer: “Which way does causality run?” he asked. “If we give a company a subsidy to locate in a city, it doesn’t guarantee that company will produce economic growth.”

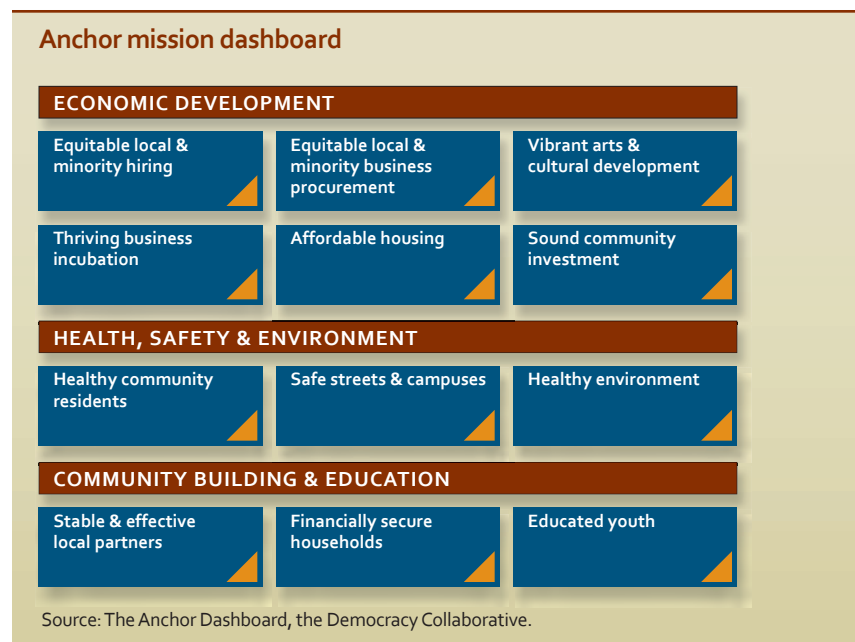
Ted Howard, founder and executive director of the Democracy Collaborative at the University of Maryland and Steve Minter, fellow at the Cleveland Foundation, introduced the “anchor dashboard” as one way to make sense of causality. Howard is the social entrepreneur who designed the Evergreen Cooperative Initiative, informally known as the “Cleveland Model.” A green-jobs and wealth-building strategy, the Cleveland Model demonstrates a new approach to community development that creates economic prosperity by democratizing wealth and ownership. Leveraging anchor institutions for community benefit incorporates some key components of this model, including anchoring jobs locally and stopping dollars from leaving communities.

Defining anchors

The importance of anchors to their surrounding neighborhoods is well known to many, but what qualifies as an anchor is not exactly agreed upon. Deciding where the most opportunity lies for anchors to help their communities, said Global Cleveland’s Joy Roller, “depends on how you define anchor institutions.” She defines them broadly as organizations impacted by population loss. For Howard, though, anchors are large, place-based institutions, usually nonprofits with a social mission, usually large employers and strong local economic engines. Universities, hospitals, local governments, community foundations, and cultural institutions are prime examples.

According to Howard, anchors are truly rooted and have a vested interest in their surrounding communities. “Anchor institutions may reasonably be expected to be around in 100 years. Anchors take the long view and get dividends later,” says Howard. Companies can exhibit anchor-like behavior, but he “would exclude companies that stay in the area only when it makes sense for the investors. If the companies can be more profitable somewhere else, they will move.”

Others think we may be “too captive to the past,” one Philadelphia participant noted, “by limiting our definition of anchor institutions,” especially to the “eds and meds.” In fact, while universities and hospitals represent the legacy of the industrial wealth once enjoyed in Rust Belt cities, how and where they deliver services continues to evolve. Tom Schorgl of Community Partnership for the Arts agreed, noting that anchors can also be “neighborhood-based institutions or groups that provide an anchor in those neighborhoods.”



How anchors support the economy

However you define anchors, the definitions have one thing in common: Anchors spur economic activity in and around them. According to Howard, anchors and their largely untapped potential in procurement spending have the power to change whole markets and transform the local community. For example, under its Vision 2010 plan, the University Hospital system in Cleveland spent \$1.2 billion on construction of new facilities. Over 90 percent of the contractors used were local companies, 17 percent of them minority-owned businesses. Close to 20 percent of the workers were local residents. The system worked with 110 small companies during construction and it continues to work with 30. Anchor institution strategies help fill the economic void in the absence of big companies.

For Howard, “if an economy is going to improve in an area, it needs to include everybody in the improvement.” For this to happen, business, human capital, and community needs must be in alignment. Yet there is more work to be done on this front. “You can stand at the front door of any major hospital in an urban area, and it’s a beautiful facility,” says Walter Wright of the Cleveland Foundation. “Walk 100 yards in any direction and you can be in deep poverty.”

Some see an uneven power dynamic between anchors and community residents. Anchor strategies can lead to gentrification, which eventually pushes local residents out of the community. “There is a history that needs to be overcome,” Howard says. “There is a great feeling still that institutions don’t care about us, aren’t for us, or are out to get us.”

To address these concerns, we need to know if strategies are working. Howard recently co-authored a new report in which he suggests indicators for anchors interested in assessing whether or not their practices promote community benefit. The Anchor Dashboard, developed through field research, suggests performance measures for institutions to establish baseline conditions in a community and then track the anchor institution’s impact on that community through spending, procuring locally, hiring of employees, and other factors that contribute to the long-term welfare of the community. “Metrics must include a measure of how investments in the area help retain and improve outcomes for low- and moderate-income residents,” Howard explained, “and not just of diverting procurement dollars to local suppliers.”

Room also exists for partnerships between anchor institutions and small businesses. Sean Watterson, owner of the Cleveland bar and restaurant, Happy Dog, shared a message with public leaders: “Don’t lose sight of what smaller businesses around anchor institutions can contribute,” he said. Local governments can support synergies by creating a positive climate through providing security measures, investments in infrastructure, land disposition decisions, historic preservation, and funding.

Arts and culture

Cultural institutions — museums, performing arts centers, theaters — by many accounts are considered anchor institutions, and they certainly provide the same benefits to their communities that other anchors do. But cultural institutions, and to a further extent, the arts in general, can offer benefits above and beyond being anchors. In fact, according to a survey by the US Bureau of Economic Analysis and the National Endowment for the Arts, 3.2 percent — or \$504 billion — of current-dollar GDP in 2011 was attributable to arts and culture. That’s an incredible number, considering that the BEA’s estimated value of the US travel and tourism industry was 2.8 percent of GDP.

Many Rust Belt cities have a thriving arts culture, and the four cities involved in the videoconference series see an opportunity to leverage that culture for community and economic development. “Where arts and culture are, economic development follows,” says Mari Hulick, a professor at the Cleveland Institute of Art. “Artists have been known for gentrifying every part of this country.” Even if the money doesn’t necessarily wind up in the artists’ pockets, the investment is worth it. “People are attracted to the arts. They think it’s cool, and fun, and exciting,” says Wright of the Cleveland Foundation. “Once you get some energy around the arts, you will start to attract investment and population and energy.”

Such is the case for the Gordon Square Arts District, a Cleveland neighborhood where an economic regional development strategy centered on three theaters was executed in 2003. Matt Zone, a City of Cleveland Councilman, represents the area: “Flash forward 10 years; we have about three quarters of a billion dollars of economic vitality that is going on.” Global Cleveland’s Joy Roller also knows a thing or two about the area: She was the executive director of the project. “Art is the key,” she says, “because that’s the kind of lifestyle element that is going to attract people to place, and place-based development is critical to how we’re going to rebuild the inner cities of the cities that we’re talking about here.” Sharing this strategy and its success story is one of the main benefits of hosting this videoconference series. “I think others can learn a lot from the hard work that we’ve done here in Cleveland,” Zone said.

Defining the arts

As with the definition of anchor, the definition of arts spurred conversation. Traditionally, arts and culture organizations have been defined somewhat narrowly as not-for-profit institutions. These types of institutions are important in many ways, such as providing jobs and other economic activity. But there's also the for-profit side of arts and culture, says Schorgl. In music, it might be recording studios or musical instrument manufacturers. "It could be any number of for-profit businesses," he says. "They provide a lot of good paying jobs and are important when it comes to importing and exporting dollars into the community." In fact, the leading contributing industries of that 3.2 percent of current-dollar GDP in 2011 attributable to arts and culture, says the survey, were motion picture and video production, advertising services, cable television production and distribution, publishing, and the performing arts.

Cleveland could be primed to take advantage of that for-profit segment, at least according to Sean Watterson of Happy Dog. He sees opportunity all around. "We need to create incentives to record and produce music in the region," says Watterson, "so that we can take advantage of the assets we have. We have graduates from the Cleveland Institute of Music and Cleveland Orchestra members and Apollo's Fire members." Working with local law and business schools to develop the management and the representation for the arts is also a wide-open opportunity. Not only does it prepare individuals for a promising career; it provides artists with the resources to make a living by generating revenue in the markets they serve.

Of course, there is no perfect solution. The arts, after all, require subsidy, both personal subsidy—think starving artist—and institutional subsidy. You have to establish an arts community before businesses can figure out how to make money around it. But many think it's worth the investment. To be sure, the arts are not essential for life, says Hulick. "Food is. Oxygen is. Those things are essential for life. But art is what makes life worth living, and everybody knows that."

Arts and cultural production as a percentage of US GDP

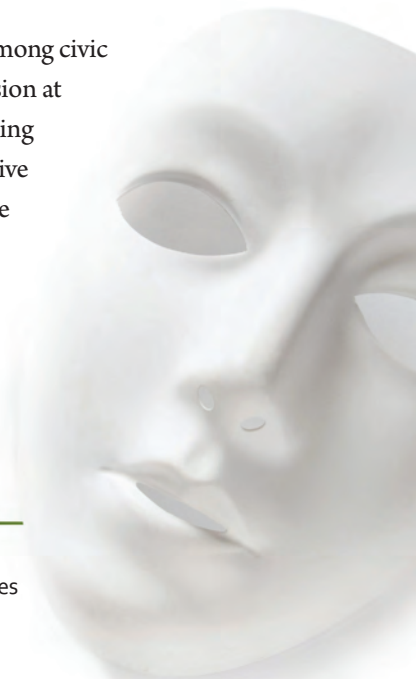


Source: Arts and Cultural Production Satellite Account (ACPSA), US Bureau of Economic Analysis.

Continuing the conversation

Part of how the Federal Reserve approaches its dual mandate of full employment and price stability is through creating forums where our stakeholders can talk with and learn from each other. By bringing together key players in community and economic development, we deepen our understanding of regional issues and bring forth the realization that one area's struggles might be another's solution.

The Redefining Rustbelt conversations among civic leaders will conclude at an in-person session at the Philadelphia Fed's biennial Reinventing Older Cities conference in May. A collective summary of the videoconferences will be published this year, and video archives of the session will be available. ■



Watch video clips

Watch Rust Belt reps share strategies for revitalizing their cities at www.clevelandfed.org/forefront



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Interview with Eldar Shafir

The behavioral scientist counsels *Forefront* on why people are not really rational in the way that economists like to think they are.

Economists work under the assumption that people make rational decisions. Psychologists don't, at least not in the way traditional economists think about the rational model. Behavioral scientist Eldar Shafir straddles both worlds. In his quest to relieve the tension between rational versus real life, Shafir reminds us that conflict, context, and uncertainty can't be accounted for.

Eldar Shafir is the William Stewart Tod Professor of Psychology and Public Affairs at Princeton University, and co-founder and scientific director at ideas42, a social science R&D lab. His current research focuses on decision-making in contexts of poverty and on the application of behavioral research to policy.

Shafir was a keynote speaker at the Federal Reserve Bank of Cleveland's Policy Summit on Housing, Human Capital, and Inequality in September 2013. Mark Sniderman, the Cleveland Fed's executive vice president and chief policy officer, interviewed Shafir during his visit. An edited transcript follows.



Sniderman: *You began your career as a cognitive scientist, but now are in the business of behavioral economics. How did that happen?*

Shafir: While at MIT, I attended a series of lectures by Amos Tversky [a cognitive psychologist who challenged economic theory by showing that people frequently do not behave rationally]. I didn't even know the topic before, but I was blown away and thought it was wonderful and ended up going to work with him. Soon after, I wrote my first real economics-focused paper with Amos and Peter Diamond [an economist and professor at MIT].

To me, it felt very much like psychology. We were just asking about people's perception of money, just like any psychologist would do, but it ended up fitting very well with an interesting set of issues having to do with economics. I found myself reading about the Phillips curve much more than I would have otherwise! But the research felt very behavioral. It didn't feel like I had stopped doing something and now I was doing something else; I was doing the same thing.

Sniderman: *Are there fundamental differences, nevertheless, in how economists and psychologists think about the way people make decisions?*

Shafir: Yes. There are some young behavioral economists who are starting to change those intuitions a bit. But I think the classical economists really are kind of enamored with and believe in the idea that people make — on the whole, to a large extent — rational decisions. That might fail occasionally, but altogether, when people attend to things and care enough, they make rational decisions as in the rational model. I think many psychologists would rarely even consider that a possibility.

Classical economists really are kind of enamored with and believe in the idea that people make — on the whole, to a large extent — rational decisions.

Sniderman: *Economists make the fundamental assumption that if people had all the information, they would process it in a logical way. Do you think that can or should change in economics?*

Shafir: I can divide economists into two camps. There are those who do their work on rational agents, and it's beautiful work and quite sophisticated and they see no reason to go any further. It's about an idealized world in which people are rational. Then there are economists who want to have an impact on real life, who want to enter policy issues and have work that's relevant to real human affairs. I think the latter will have to change their assumptions because it's pretty clear right now those assumptions do not capture very well what people do.

One thing that's good to keep in mind is that the rational model of economics, though it fails to describe people, is an empirical product in a sense. It correctly describes what people think it means to be rational; it's not just a philosophical creation that went nowhere. Rational analysis is actually a pretty deep empirical description — not of what people do — but of what they consider to be a rational way of going about making decisions. It's not a theory that was debunked and thrown away; it's a theory that really captures the heart and mind of many people. It's very appealing and also has a force of being right in some deep way. It's not about what we do, but how we would like to act. It's a little bit like ethics. You're not going to throw away the Ten Commandments because it turns out people violate them. They're still there, they're still good; it's just they're not a good description of how we act. So it's not that there is a good theory and a bad theory, but rather opposing weights on what people consider is the right thing to do and what people in fact do in practice.

Sniderman: *Could we simply relax the assumption that people are processing information in a rational way, allowing for a certain type of bias in the model and then still use all the math to solve it?*

Shafir: People have tried that within very limited models on specific domains, to keep the structure and relax some assumptions, but I think in the grander scheme of things, apart from selectively modeling very specific phenomena, the changes would have to be massive.

Maybe we're lacking imagination. Maybe there will be a new cohort or way of thinking about it that will retain some of the beautifully sophisticated economic instruments, and yet manage to become more faithful to what people actually do. But for now at least, we have on the one hand models that are very impressive, but even with all the relaxations, still fail to capture what people actually do. And then we have the psychology, which sort of lacks a good general model. Psychology provides a collection of interesting phenomena and interesting observations and some very nice theories, but they're always very specific to the area where you work. There isn't a generalized model that anybody can just grab and use in the behavioral sciences. We just haven't reached anything like that. It looks from here like we never will, but you never know.

Sniderman: *Is there an equivalent in behavioral psychology to economists' rational agents?*

Shafir: Psychologists don't think that way. Those who study decisionmaking basically study some specific aspect of individuals' decisions, though they may use mathematical structures to try to model what they're studying. Similarly, for the study of vision, color perception, divided attention, language acquisition, stereotyping, conformity,



or other very technical or less technical areas. It's always highly compartmentalized to specific areas of cognitive function or behavior and it never gets to the generalized level of formalism and cleanliness that you get from economic theorizing.

Sniderman: *You've pointed out that sometimes people behave in the real world in ways that are not at all what you would predict from lab experiments. Can you expand on this?*

Shafir: This problem is true for my field, but also for pharmaceuticals, nutrition, experimental game theory, or anything else. Studies do not always capture what happens when people start living their normal lives. It's certainly true in the behavioral sciences. I think to some extent one develops a bit of an intuition. What are the kinds of cases that will extend more easily than others? If I study your capacity to retain a number of items in short-term memory, it's not clear why everyday life will be very different from a lab. But if I decide to study your tendency to contribute to charitable organizations, or to exercise, of course in a lab you can do and believe you do things you'd never do in real life. So a lot depends on the extent to which you might expect a divide between lab-based and real world or field experiments.

Having said that, the dream in many cases is to basically do both. You often start from the lab to see if you have a phenomenon that seems to be real, then you go out there and see if it replicates or if it extends to real settings. It gets even messier than that because in behavioral science, even when you

replicate it in Washington it doesn't mean you replicate it, in precisely the same format, in Stockholm. It gets trickier. There are general principles that you can replicate. So, for example, we know that people pay more attention to some things and that they pay less attention to others, and that's going to influence what they do, and that's going to replicate. But what it is they pay attention to and what they neglect might differ from place to place. So, again, it might take a little bit of intuitive juggling to understand what might replicate from place to place and what might not, without some relevant changes.

We did a big study a few years ago where we sent letters to clients of a money lender in South Africa inviting them to apply for a loan. Among the things we manipulated was the interest rate that was offered to people randomly—from 3 to 12 percent monthly. Along with that, we manipulated several other dimensions of the letter, like whether you had a picture of a man or a woman or no picture at all at the bottom of the letter. We did all the comparisons among 60,000 participants and they showed that as the interest rate went up, the take-up of the loans went down (as you would expect). But when we switched the picture on the bottom of this letter from a man to a woman, take-up of the loan (this was three months of people's actual income—these were all real loans taken) was the same as roughly lowering interest four and a half percentage points monthly.

So, what do we learn there? We learn, from my perspective, that little manipulations can have an impact much greater than we thought. I wouldn't say we learn that switching the picture from a woman to a man or from a man to a woman in, say, Germany, would get the same result. You might have to make a bigger switch or a more subtle one. Those nuances will change from place to place, but the fact that people's attention is captured by small elements of which they're unaware and shapes

what they do—that's what I would say is rather universal. So that's the game you play: You can try and find universals that drive human behavior, realizing that the nuances, the details, the extent of the effects will change from one context to another and in the lab.

Sniderman: *Is it possible that people will become more aware of their environment being manipulated and, consequently, learn to neutralize it?*

Shafir: Awareness is good. When you're offered three for the price of two, you detect and you notice that manipulation. You might grow more accustomed to it and be less enthralled every time this happens. But a lot of things having to do with persuasion and behavior change are at a level that you don't even perceive. You wouldn't even know that it's happening to you at that moment. You wouldn't understand that it is a manipulation. So in those cases, it's very unlikely people will learn to be immune to it.

Sniderman: *There's been a lot of discussion in the last several years about decision architecture, especially in regard to public programs. Many believe that people should manage their own affairs and question if it's appropriate for the government to get involved. You have said that you don't think it's fair to blame people for not making good decisions. Can you elaborate on that?*

Shafir: The mistrust of government at some level is a perfectly healthy thing, and we can come back to that. As far as choice architecture and blaming people for not making good decisions goes, to my mind it gets almost silly. Let's say I assume that people can walk anywhere they want really quickly. Then I announce a conference in Washington, DC, this evening and tell you to be there. You can't do it. Now I could hold you responsible for not having enough motivation—you didn't walk from Cleveland to DC in an hour. That's sort of what happens

with some of our assumptions. There are clear limitations to what people do that have been carefully investigated and documented. Some things we just can't do well. Assigning blame for not doing them well borders on the comical.

Consider the amount of bandwidth a person has available at any one time to process information. Some people have too much going on and too many things to take care of to be able to manage their finances well, but you're assuming otherwise and then holding them responsible for doing things badly.

Sniderman: *So you take issue with the assumption part?*

Shafir: It's the misunderstanding of what motivates people, what they're capable of, how they divide their attention, what they're able and not able to do at any point in time that leads you to leave them responsible for things that—no matter how good they are—they're bound to fail at very often. You either have to digest this and accept that your assumptions are not right and change them, or you're going to get into a situation where people are just conducting less successful lives and are blamed for it.

Sniderman: *In the private markets there are those who are engaged in overtly appealing to consumers' biases to lead them to make choices that they might regret but would be profitable to the company. Do you think it is appropriate for the government to try to neutralize that through various kinds of interventions?*

Shafir: I think people are going to be influenced by things that they wish they weren't—everything from commercials, to smells, to all kinds of at-the-moment, urgent offers that are highly appealing. We have a lot of questionable players in the market who take advantage of and hurt people. There are two options: you outlaw them or you enter the game yourself—"you" being well-intentioned policy and government organizations. I think outlawing all of them is probably inadvisable and unlikely, so I think the best thing to do is swallow our pride a little bit and enter a world where we do some "publicity." We typically feel it is below us to appeal to people in ways that are not respectable and on the table, but that's how people's behavior is shaped so we need to take it seriously.

The other option is to question far more seriously the actions of the bad guys. I don't think the notion that a free market needs to incorporate a lot of unethical behavior is necessarily in the original idea. It's a recent, to some extent American, development. And the idea that you're playing the free market, with minimal consumer protections, and also are allowed to be dishonest maybe should change. I think more restrictions and consumer protections and heavier penalties on unfair players who are predatory on the less capable seem very plausible, but in today's climate it's probably not going to happen tomorrow.

Sniderman: *Where do you weigh in on the nudge debate—where government doesn't tell you what to do, but gently biases the context so that you find it easier to do things you think are in your own self-interest?*

Shafir: It's compelling enough to give it a real try. Of course, not everything is "nudge-able." Perhaps, in times when something else is needed, the attempt to nudge could go too far or not be enough. You can either not do enough and have people fail or you can do too much and have them fail.

Eldar Shafir

Position

William Stewart Tod Professor of Psychology and Public Affairs, Princeton University

Former Positions

Fellow, The Institute for Advanced Studies of the Hebrew University

Professor, DUXX Graduate School of Business Leadership, Monterrey, Mexico

Honors and Awards

John Simon Guggenheim Memorial Foundation Fellowship, 2012

Member, US President's Advisory Council on Financial Capability, 2012–2013

David C. Baum Memorial Lecture, University of Illinois College of Law, 2012

President, Society for Judgment and Decision-making, 2010–2011

Education

Brown University, BA

Massachusetts Institute of Technology, PhD

Selected Publications

Scarcity: Why Having Too Little Means So Much, with Sendhil Mullainathan. NY: Henry Holt Times Books. (2013).

"The Martyrdom Effect: When Pain and Effort Increase Prosocial Contributions," with Christopher Olivola. *Journal of Behavioral Decision Making*, vol. 26, issue 1, pp. 91–105 (2013).

"The conflicting choices of alternating selves," with Robyn LeBoeuf and Julia Belyavsky Bayuk. *Organizational Behavior and Human Decision Processes*, vol. 111, issue 1, pp. 48–61 (2010).

"Reason-based choice," with Itamar Simonson and Amos Tversky. *Cognition*, vol. 49, issue 2, pp. 11–36 (1993).



I don't know if trial and error is the best approach, but we need to institute systems that help us see how the work can be adjusted for the best outcome, which is what we do with everything else. We create new inventions, new medications, new treatments, and then we see what works and what doesn't and we adjust. In some sense, I think we're going to have to do that here, too. Clearly at some point if you take it too far, there is the sense that people could lose their own individualism and responsibility and the sense that government might not choose well. It's a fine balancing game.

Sniderman: *Have private companies tried to make positive changes for employees or customers by nudging them to make good decisions?*

Shafir: Sure. Opower is a company that's gotten a lot of press in recent years. It's a company that's devoted to saving energy. It's well-informed on the behavioral literature and is using various interventions and installing all kinds of gadgets in people's homes; contraptions that change color and beep according to energy consumption, as well as letters and flyers that are carefully designed. These things can have an enormous impact on energy saving. Another example: The GlowCap is a privately produced little plastic capsule for delivering medication that seems to have had

an enormous impact on people's compliance and adherence to taking their medications. It's very cheap, it's sold privately, and it's having a huge positive effect on health. I think we're going to see more and more of that.

Sniderman: *You recently served as a member on the President's Advisory Council on Financial Capability, a group representing the financial industry, foundations, public interest groups, and financial regulators. What did you learn?*

Shafir: What I learned, which I knew I would, is the difficulty of implementing any good idea in the real world. That's something that you saw very clearly in these meetings, where people are trying to do anything from financial education to workplace environments. You encounter the big obstacles once you have some good ideas. I got a lot better sense of all that.

I think people were very open to the behavioral notions to which many of them had not been exposed to significantly before. Many of them were really very eager to get a better sense of what the behavioral perspective could contribute. It figured very clearly in the final report we gave to the President. I think it's a mini, mini step, but it's in the right direction.

Sniderman: *Do you see the application of this way of thinking about people and their decision making spreading to all areas of social sciences?*

Shafir: In some disciplines I assume that specific assumptions about human behavior play a bigger role than in others. In general, though, I think that our emerging conception of what drives people and how they behave is not quite the one that we would have anticipated intuitively. Studies show that it's quite different.

The Woodrow Wilson School of Public and International Affairs [at Princeton University] now has a required course that all the MPA students take: psychology for policy. It's a course that students resented enormously initially and now they mostly love, and we're adding more courses because they want more of this stuff. I think a lot of policymakers will be trained now to have a better conception of what drives people. Various social science disciplines will probably differ a lot in what they do with this more nuanced understanding, and how much it comes to form a central element of their conception of people, but I think it will, in fact, enter many disciplines.

Sniderman: *Do people in other countries think about behavior differently, especially when it comes to financial capability, than those in the United States? If so, how?*

Shafir: I think there's a sense in which the support systems here are less developed than they are in parts of Western Europe, for example. Here, there's a little bit more of a sense that people are responsible for their own destiny and should be left to their own devices.

Sniderman: *What sort of support systems do you mean?*

Shafir: Jails, for example, are friendlier and more pleasant in Europe because the perception is that you're there partly because of bad luck, whereas here it's something you did and, consequently, you deserve the miserable conditions you get. And this way of thinking pertains to the poor, too. There's this ethic that says you're responsible for your destiny and if things go wrong, it's you who did it and we owe you very little. I think the Europeans' perception—and there's some research on this—is that when you're poor or incarcerated or whatever, a substantial proportion is attributed to bad luck. "There, but for the grace of God [go I]." That influences how policy is conducted.

Sniderman: *Some research done on poverty suggests that decisions made early in life (having to do with education, the age of having a child, and getting married, for example) may enormously influence one's relationship to poverty. In your work, you seem to stress that poverty itself can contribute to poor conditions. Can you talk more about this causality issue?*

Shafir: There's no doubt that if you grow up in contexts of poverty, you suffer educationally, biologically, culturally, and in every way possible. So you clearly grow up handicapped in many ways. The question is, what happens next? And are you able to transcend it? There's been some evidence of programs that help.

What Sendhil Mullainathan and I focus on in our book [*Scarcity: Why Having Too Little Means So Much*] is essentially the cognitive life inhabited by the poor, which is, to a large extent, ahistorical. It's moment-to-moment: how you spend your mental bandwidth taking care of all the things you need to take care of. And what our studies show is that if you take anybody and put them in the context of poverty, they start doing things less well. Everything suffers. If you take them out of poverty, they start paying attention outside the confines of juggling the day-to-day and start doing well elsewhere. All this certainly doesn't argue against the notion that you suffer biologically in ways that take a very long time—if ever—to recover from if you're raised in abject poverty. And we're talking about America, we're not even talking about the Third World, where poverty can be more extreme.

There are, by the way, issues of relative poverty that are quite intricate. There's a world in which when you talk about the American poor, people come and say "What are you talking about? Everybody in America has air conditioning and toasters and TVs." Adam Smith resolved that puzzle 250 years ago when he talked about the laborer in

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England who used to not need a linen shirt to go to work, but now that he's expected to have one, Smith explains, if he cannot afford one, he's poor. So clearly standards change.

And what it means to be poor changes with them. Recently the Heritage Foundation reported that most of the poor do not suffer from material hardship, as exemplified by the fact that most people defined as poor have air conditioning, microwaves, and DVD players. My guess is that this characterization of what it means to be poor makes initial sense to many people, because unless you think about it carefully, it sort of sounds reasonable. But it's not. Imagine if the report had said all the poor have running water.

The context in which you live determines what is considered minimally acceptable. Running water was once a luxury, but now it is considered part of a minimally acceptable American life. So if you don't have it, you may feel poor. There are certain things that you expect to have for a minimally acceptable American life today if you are in America or Swedish life if you are in Sweden. That's a very behavioral notion, a simple psychological notion. Internet was a major luxury a while ago, but now if you can't afford it, you feel poor. Sometimes it's hard to deal with this issue because some people's perception of poverty comes close to something approaching starvation. So they think that not having internet or a car has nothing to do with being poor. But, in fact, internet and a car and a TV, like water, have become part of basic American life. As per Adam Smith, if you cannot live a minimally acceptable life in the time and place in which you live, you're going to feel poor.

And when you live poor, behaviorally what we find is that contexts in which you feel you do not have enough tend to capture your mind and make you attend to them at the expense of other things, and that ends up impoverishing you in other ways.

Sniderman: *What are you working on today that you hope will bear fruit in the next five or ten years?*

Shafir: We're hoping to start a center for behavioral policy at the Woodrow Wilson School at Princeton that will bring together researchers and students from different disciplines, who are focused on these behavioral issues. I think figuring out to what extent we can infiltrate and have some real impact on policymaking anywhere from government to nonprofits will be the agenda for the next few years. It seems a like good moment. The United Kingdom has the Behavioral Insights Team (also known as the "nudge unit"); that's David Cameron's actual office for doing behaviorally informed work, and the White House and Treasury are now starting with a similar project. So I think there's going to be more of that behavioral perspective entering policymaking and that's possibly something I'd devote some serious attention to.

Sniderman: *Thank you.* ■



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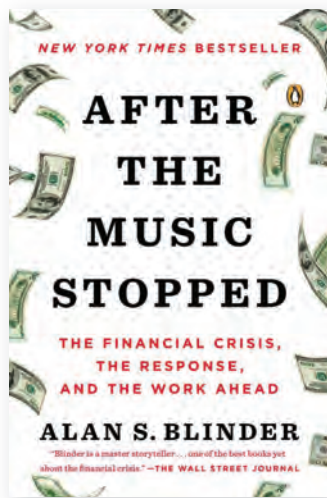


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Book Review



After the Music Stopped: The Financial Crisis, the Response, and the Work Ahead

by Alan S. Blinder
Penguin Press, 2013

Our reviewer says this book is a keeper, with lasting importance about the origins of the financial crisis and 10 financial commandments for the way forward.



Reviewed by
Doug Campbell
Executive Speechwriter

Even if you are suffering from financial-crisis-retrospective fatigue, you should still read Alan Blinder's *After the Music Stopped: The Financial Crisis, the Response, and the Work Ahead*. But it is perfectly acceptable to skim the first three-fourths and jump straight to the final section, "Looking Ahead."

Time, after all, is short. 2013 was chock-full of five-year reminiscences and ruminations on the financial crisis. Lehman Brothers, AIG, "breaking the buck," and TARP—been there, read that.

As a service to readers, here is a synopsis of *After the Music Stopped*, Parts 1-3: The crisis was caused by a housing bubble and a bond bubble; too much leverage; too little financial market supervision and regulation; too

much complexity and opacity in financial instruments; the shadow banking system; and "disgraceful" subprime lending practices. Financial market reform is messy and continues.

The first sections I just described of *After the Music Stopped* unfold in mostly chronological and highly readable form. Unlike journalists who deal mostly in he-said/she-said accounting, Blinder focuses his attention on explaining the origins of the crisis. Readers looking for insider gossip would do better with David Wessel's *In Fed We Trust* and Henry Paulson's *On the Brink*. In taking time to carefully explain the "why" of the past, Blinder builds a coherent bridge to the future.

Now that you are caught up, we can discuss the lasting importance of *After the Music Stopped*. Even a year after its publication, the issues Blinder explores in his wrap-up section remain relevant and, for the most part, sadly unaddressed.

Blinder is a decorated Princeton University economist, author of multiple textbooks, and a former Federal Reserve governor and White House adviser. In other words, Blinder has a neat combination of academic chops and political savvy. This is no campus-bound theoretical discussion with little connection to the real world. Blinder speaks with the versatility of a man who can write a complicated model on a whiteboard, explain it in accessible terms in a *Wall Street Journal* op-ed, and then bring it to life in a back-room deal on Capitol Hill.

Although the initial mess from the financial crisis fallout has been cleaned up, there remains a lot on America's to-do list. In the final sections, Blinder summarizes the lessons learned in a list of "10 Financial Commandments," which include things like: people are forgetful, self-regulation doesn't work, too much leverage is a bad thing, avoid complexity, and protect consumers. That these lessons are delivered so clearly is testament to Blinder's skill as an analyst and communicator—he makes the causes of the financial crisis sound simple, or at least understandable.

Then, Blinder puts on his pragmatic policymaker hat with some rules of thumb for the way forward: Don't try to do too much at once; explain yourself; set expectations low; and pay attention to the zeitgeist (i.e., people's attitudes, prejudices, and misconceptions). These are words of wisdom from an experienced Washington hand.

Blinder doesn't rely on vague heuristics, of course. He identifies health care costs as the single most crucial long-run problem for America to solve. He notes that the Federal Reserve's bloated balance sheet puts us in uncharted and dangerous territory. The moral hazard problem (loosely, too big to fail) seems unlikely to be settled even with reforms under Dodd–Frank. And he faults everybody for letting the foreclosure epidemic inflict lasting damage on neighborhoods across the country. All of this is supported by data and tables presented in easily digestible bites.

Overall, Blinder doesn't forecast economic ruination or redemption. He mostly acknowledges the challenges awaiting anyone wanting to take on seriously the enduring problems: "The experience in the United States in the years since the bubbles burst has been tremendously costly; the heavy price we paid was certainly too high for whatever we learned. But we did learn something. And we need to remember those lessons the next time big financial ructions strike. Sadly, the forgetting has already begun."

Blinder focuses his attention on explaining the origins of the crisis.

Some critics of *After the Music Stopped* have called out Blinder for being overly optimistic about the government's ability to make things better. And it is true that where others see opportunities for market discipline, Blinder observes the need for stepped-up government intervention. The essential paradox of the entire financial crisis episode, Blinder says, was that the government emerged as the villain, even as it was under-regulated markets that caused the crash and government that saved the day.

Another view of Blinder is that as an economist, he is pretty middle-of-the-road. It's a sign of the times—and a cautionary note about the difficulty of finding common ground on the work ahead—that he is viewed as anything else.

Extras worth checking out in the book:

- Helpful sidebars explaining economic and financial terms such as "moral hazard" and "insolvency versus illiquidity."
- A table highlighting the major events leading up to and during the financial crisis.
- A reference to the Cleveland Fed's Joe Haubrich's early work on understanding financial market "toxic waste." ■

Farewell, Dear Readers

Forefront's editor in chief says goodbye.



Mark Sniderman
Executive Vice President and Chief Policy Officer
Forefront Editor in Chief

Dear Readers:

When I conceived *Forefront*, my objective was to take the knowledge we accumulate inside the Bank and bring it to you, the readers, who are outside of our organization. In fact, the working title for the publication I carried in my head was not *Forefront*, but *Inside/Out*. I liked that title for another reason: I imagined that our articles would, from time to time, take unconventional perspectives on the conventional wisdom. In that sense, we might examine ideas from all angles, “inside and out.” For reasons not worth belaboring, we went with *Forefront* instead of *Inside/Out*.

This issue of *Forefront* is my last, as I am retiring from the Bank. I will leave it to others to judge whether the publication measured up to my aspiration. For my part, I can say with assurance that we did our best to give you a window to our thinking about a broad range of economic policy topics.

To be candid with you, *Forefront* serves a strictly internal purpose as well, which is to promote a culture of cross-functional strategic thinking and operations within our Bank. All organizations are looking for ways to break down silos and encourage problem identification and resolution from different viewpoints. One of my goals for *Forefront* was for it to help us build a better Bank.

For me, interviewing outside experts has been the most fun and stimulating aspect of each *Forefront* issue. These experts often challenge us to think differently about the world we live in, and to consider policy solutions that we might not have taken as seriously as we ought to, or even put on the table. I gained valuable insights from every person I interviewed and find myself going back into the text to rediscover something that we discussed. I wish I had the space to explain what I found so stimulating about each one, but space doesn't permit that. Nevertheless, let me randomly cite a few that illustrate the power of economic logic applied to public policy issues, as well as define some of the limitations of that logic.

My first interview was with Anil Kashyup at the University of Chicago in 2010, in the wake of the financial crisis, while the Dodd–Frank Act was taking shape. Kashyup discussed the reasons for the crisis and what he regarded as the course of action that Congress and the financial regulators should take. There is a lot of meat in that story, and I think it is a good read.

Later that year I interviewed Art Rolnick on the subject of early childhood education. Rolnick maintains that investment in high-quality pre-K programs can achieve greater returns than investments in most other kinds of public programs. Since then, the topic has received increasing attention, and many states and cities have rolled out new programs. I regard this as an extremely important public policy issue and would like to see more people informed about it.

Price Fishback from the University of Arizona sat down with me in 2011 to discuss similarities and differences between the Great Depression and the Great Recession, and Barry Eichengreen talked with me last year about economic history more generally.

I gained valuable insights from every person I interviewed and find myself going back into the text to rediscover something that we discussed.

Kashyup discussed the reasons for the crisis and what he regarded as the course of action that Congress and the financial regulators should take.

Rolnick maintains that investment in high-quality pre-K programs can achieve greater returns than investments in most other kinds of public programs.

[Fishback and Eichengreen] reminded me of the valuable role that economic history can play in the formulation of current economic policies.

Each of these conversations reminded me of the valuable role that economic history can play in the formulation of current economic policies. As they say, history may not repeat itself, but it rhymes.

The last interview I will call out is the one in this issue, with Princeton's cognitive scientist Eldar Shafir. Shafir contrasts psychologists' and economists' views about human decisionmaking [Spoiler alert: economists beware!]. His analysis illustrates why consumers are prone to making poor choices in the marketplace, and why protecting consumers from unscrupulous sellers is not as easy as you might think.

These and other interviews, along with the rest of *Forefront*, are examples of the ongoing conversation we want to have with you, our readers, about the vital economic issues of our times. As I shift my own role from editor to reader, I firmly intend to remain involved in that conversation. *Forefront* staff, bring it on! ■

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