TEN

FEDERAL RESERVE BANK OF KANSAS CITY

Summer 2008

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Defense spending has significant presence in the region

TEN

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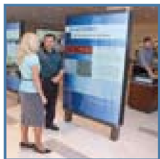

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The Financial Crisis and the Federal Reserve's Response

Tom Hoenig, president of the Federal Reserve Bank of Kansas City, delivered this speech May 6 in Denver, Colo. To read the entire speech, visit KansasCityFed.org/TEN.

I am pleased to be in Denver and I appreciate the opportunity to talk with you about current economic and financial market developments. As you know, the past several months have been a very difficult period for the U.S. economy. A sharp slowdown in growth has put the economy at the brink of a recession while, at the same time, rising commodity prices have caused inflation pressures to rise considerably. And, to make matters worse, these events have occurred against the backdrop of a collapse in housing markets that has shaken financial markets around the world.

The Federal Reserve has responded to these developments aggressively. It has taken unprecedented actions to provide increased liquidity to banks and other financial market participants to maintain the functioning of financial markets. And, it has eased monetary policy considerably to try to ensure that the disruptions in financial markets do not spread to the broader economy.

Despite current difficulties, in my view there is room for optimism about the near-term outlook for the U.S. economy. Financial markets appear to have stabilized somewhat, and the economy should pick up in the second half of the year as fiscal and monetary stimuli takes hold. The damage to financial markets is severe, however, and it is likely to be some time before they are able to function normally. Indeed, I believe that major changes in industry practices and a significant rethinking of financial regulation will be required if we are to avoid similar problems in the future.

Market turmoil

Let me provide a more detailed discussion of the disruptions in financial markets that have occurred over the past several months and the Federal Reserve's response to these events. It is a simple fact of history that, over a business cycle, markets tend toward excess optimism in which risk is seriously underestimated. In some cases, public policy is required to "bail out" undeserving parties so as to minimize the broader impact on the economy. It is also a fact that no matter the source of the financial problem, no matter the size of the institution or the region in which the problem emerges, the Federal Reserve will be part of any solution that is developed. This was the case in the '70s, '80s and '90s during the foreign debt, farm, real estate and energy crises, and is the case today. As a necessary principal party in prudential supervision and as the lender of last resort, the Federal Reserve is best positioned for this task.

Most in this room are by now well aware of the role that subprime lending played in the creation of the housing bubble and its collapse. However, the problems in the financial system are much broader and deeper than subprime lending. Over the past several years, we have seen the emergence of easy credit availability, new complex financial instruments and reduced credit standards by many financial institutions. This left the U.S. financial system dangerously exposed to an economic or financial shock that could cause widespread defaults and erosion of asset values. Rising subprime delinquencies provided the spark that started the financial conflagration, but there was a lot of dry tinder to spread the fire and an absence of firewalls and a sprinkler system to contain the blaze.

In recent years, subprime mortgages, like other mortgages, have been packaged into mortgage-backed securities, and these securities then served as collateral for more complex asset-backed securities. When subprime delinquencies rose unexpectedly last summer, investors in many types of asset-backed securities fled these markets, causing severe valuation declines and losses to the holders of these securities. Although banks did not make many of the original subprime loans, they held many of the affected securities and made loans to other institutions that created and held these securities. What resulted was a tremendous liquidity squeeze for the banking system and financial markets as well as large losses as the value of mortgage and other asset-backed securities declined. These strains were felt not only in the United States but also in Europe, Canada, and some other countries where banks and other financial institutions had also invested in U.S. mortgage and asset-backed securities.

To meet panic demands for liquidity, the Federal Reserve and central banks in a number of other countries have taken extraordinary steps to maintain the functioning of the financial system. In the United States the Federal Reserve has made funds available to banks and other depository institutions through its discount window and has lowered the cost of these funds. It has created a new discount window program, the Term Auction Facility, to provide additional funds to depository institutions at a market-determined rate.

The Federal Reserve also has taken a series of unprecedented actions to provide support to financial markets more generally. For example, it has broadened the range of collateral in its open market operations and security lending program. More recently, it has created a new discount window facility for the banks and investment banks that operate as primary dealers. These institutions play a key role in the Treasury securities market, and their health is important for the Federal Reserve's ability to conduct monetary policy through open market operations and for Treasury debt management operations. And, the Federal Reserve recently chose to provide direct support to Bear Stearns, a primary dealer, to facilitate its purchase.

As I indicated earlier, financial markets have stabilized recently, in part because of the Federal Reserve's timely actions. However, many of these actions were short-term in nature, and it is important that more permanent approaches be developed so that a similar crisis does not happen again. In my remaining time, I will discuss the longer-term approaches necessary to restoring and maintaining financial stability.

Steps toward financial and regulatory reform

The current financial crisis has revealed weaknesses both in the private mechanisms that financial markets employ to provide internal discipline and in our system of financial regulation and oversight. From the standpoint of private market discipline, this crisis has provided the first major test of securitization, complex financial instruments, risk modeling, and our new and broader market structure. Recent events indicate dismal test results: Many financial institutions and investors did not adequately judge, price or control the risks they assumed and did not prepare well for changing financial conditions. All of this occurred despite the wide array of new financial instruments for hedging risks and the substantial advances many market participants claimed to have made in their risk management processes.

From a regulatory perspective, existing policies and supervisory oversight came up short in several areas, most notably in identifying and addressing the exposures institutions had in certain off-balance-sheet activities and in their mortgage lending and securitization activities. These exposures, along with shortcomings in bank risk management systems, led to inadequate capital and liquidity levels and to inaccurate disclosures of risk positions to investors. Other complaints about the regulatory framework have included its failure to prevent fraudulent and abusive practices in some areas of the subprime market.

One other important regulatory concern is that many of the steps public authorities have taken over the last year to stabilize the financial system seem likely to weaken market discipline and extend moral hazard problems to a much wider financial marketplace. A key example of this, the recent sale of Bear Stearns, seems to indicate that in a crisis situation, public authorities will not be in a position to let market discipline play out when larger financial institutions encounter problems. Bear Stearns' collapse indicates that such phrases as "systemically important" and "too-big-to-fail" can even be applied to investment banks below the top tier.

The danger from a public policy perspective is that a much broader group of managers and creditors may now believe and act as if they have an added layer of protection from the risks they pursue. Beyond "too-big-to-fail" concerns, other market discipline and moral hazard problems may be inherent in some of the recent and more expansive proposals to support housing markets and in the actions the Federal Reserve had to take to provide liquidity to the market and expand discount window access.

All of these questions about our financial system are eliciting many suggestions for reform. Some have suggested that we should turn back the clock when it comes to our efforts to deregulate financial markets, and others are suggesting significant changes in the regulatory structure. However, I believe a more fundamental issue is at the heart of our problems and should remain the focus of our efforts: How can we strike an appropriate balance between risk and return in our financial marketplace, while developing the public policy steps necessary to support this framework and promote financial stability?

In a longer-run context, we have two basic means by which to strengthen and reform our financial system: promote more effective market discipline and implement an improved and more countercyclical regulatory framework.

Steps toward more effective market discipline

For our financial markets to work well, market participants must serve as a strong disciplinary force in rewarding successful ventures and curtailing funding for nonviable projects and investments. However, as shown by the current crisis, market discipline failed to prevent an overexpansion in the markets for mortgage finance and allowed a significant mispricing of the underlying risks.

Some of the factors that contributed to this market breakdown include the emergence of extremely complex and hard-to-understand financial instruments; shortcomings in regulatory oversight and poor disclosures; financial conflicts of interest; and shortcomings in corporate governance. For instance, evaluating the more complex mortgage-backed securities and collateralized debt obligations taxed the abilities of most investors. These investors were then left to rely on the credit assessments of loan originators, rating agencies, traders, and the managers of hedge funds and other investor vehicles, most of whom had competing financial incentives. Of course, the perennial factor in boom-and-bust cycles—greed-induced myopia—also played a central role as many market participants assumed that we could not have a nationwide decline in housing prices and that a continuous flow of funds would be available.

What steps should market participants take to restore their disciplinary role in the financial system and prevent the depth of problems we have recently experienced? In the near term, investors can be expected to show a preference for simpler and more readily understood financial instruments, while showing a reluctance to put their money in the types of markets and investment vehicles that have caused much of the recent turmoil. They can also be expected to exert more "due diligence" and to favor the originators, rating agencies and fund managers that demonstrate a reputation for providing sound credit analysis and accurate disclosures. These are certainly some of the most apparent "lessons to be learned," and it will take some time for our financial markets to regain the confidence of investors and meet this revised set of expectations.

Experience tells us, however, that as time passes and memories fade, market participants will always be tempted to relax their ongoing disciplinary role, particularly as any corrective steps begin to appear outmoded in a more prosperous time and as new and seemingly more profitable opportunities and investment vehicles are developed. For market discipline to be most effective over an entire cycle, it will thus be important for investors and institutions to work to establish a more resilient financial framework.

Some key areas for market participants to work on are: improving financial disclosure practices and

developing risk management processes and models that reflect a full range of economic experiences. Other needed reforms include establishing stronger corporate governance steps—including a better set of incentives for financial agents to reduce the conflicts of interest they now face—and fostering better control of liquidity risk, clearing and settlement risks, and counterparty risk.

A stronger, more countercyclical regulatory framework

Weaknesses in our regulatory system revealed by the current financial crisis also require careful thought and action. This crisis, in fact, is raising questions about such traditional supervisory issues as bank liquidity analysis, capital standards, risk management practices and off-balance-sheet exposures. Because many financial activities are gravitating beyond the banking system and into less-regulated capital markets, questions about the scope of regulation and how it can best support market discipline must be addressed.

One area where a number of large banking organizations and securities firms have fallen short is in the amount of capital they were holding against their risk exposures. It is clear that many organizations underestimated such risks and, accordingly, the amount of capital they would need. This was particularly true for a number of new off-balance-sheet activities of larger banking organizations. With the transition to Basel II international capital standards for large banks and the reliance this system will place on banks' internal risk models, it is particularly important that we make sure this approach addresses the type of problems recently encountered.

In this regard, I have a number of concerns and believe we need to be cautious as we implement the new standards. First, banks have had a fairly short history with their risk models and much of the data going into these models reflects only the period of prosperity before recent events. In fact, tests run on these models over the past few years have suggested that most large banks could safely reduce the amount of capital they hold—a premise which has now been shown to be overly optimistic. In addition, recent capital problems for larger banking associations were tied, in part, to their off-balance-sheet operations, and it is not clear whether Basel II will address these practices, as well as future banking innovations, any better than Basel I.

A final concern is that Basel II has the potential to be procyclical as bankers update their risk models to reflect new events. Consequently, if we want banks to have the capital to withstand future crises, I believe it is important for our capital standards to incorporate a longer-term view of risk and for banks to maintain a base of capital or a leverage ratio sufficient to support all their operations. A countercyclical, rules-based approach to control leverage is needed. It must be simple and observable and, thereby, enforceable.

Liquidity has been another problem for many institutions, particularly with breakdowns in the commercial paper and other funding markets, difficulties in valuing asset-backed securities and other investment vehicles, maturity mismatch problems, and questions about the financial condition of some institutions. As I mentioned previously, the Federal Reserve has taken a number of new approaches through the discount window to address these liquidity issues. We will certainly reevaluate these steps in the near future and decide what worked and whether such innovations as the liquidity facility should be continued.

We will also have to take a careful look at the moral hazard issues that might have been created by the expansion in discount window access and consider what we can do to change such perceptions. Other suggestions for reforming the discount window have also been made, such as converting some of the lending to a "line of credit" format, under which institutions could pay a fee for standby access to the window. It is also of critical importance for banking and other financial supervisors to review and strengthen their policies on liquidity; otherwise we will face many of the same problems in the future.

Because many of our current financial problems can be tied to asset-backed securities, beginning with the subprime market, we should ask ourselves what can be done to strengthen the regulatory framework surrounding securitization and to address the asymmetric information problems in this market. This is a particularly important question given the benefits that securitization can bring to our credit markets in terms of attracting new funding sources and distributing risk across a broader marketplace.

Among the ideas now being suggested are: (1) tighter registration requirements for loan originators; (2) improved disclosures by originators and securitizers on the underlying loans; (3) new limits on the types of asset-backed securities regulated institutions can hold; (4) greater liability, risk exposure or equity positions for originators and securitizers; and (5) new regulations for the agencies rating these securities.

Other regulatory steps may be necessary. For example, some have questioned whether the regulatory framework has kept up with the movement of securities firms into a broader range of activities. Where such firms once concentrated on brokerage and underwriting activities, the recent market collapse has shown that the most significant risks securities firms face are now in other areas. In regard to subprime lending regulation, the Federal Reserve has proposed a number of regulatory changes under Regulation Z and the Home Ownership and Equity Protection Act to provide greater protection to consumers and to eliminate certain deceptive or abusive practices on higher-priced mortgage loans. These amendments would also extend other protections to all mortgage loans, including additional disclosures when lenders advertise loan rates and features.

A final and very important regulatory issue is what we do with firms that might be considered "too-big-to-fail." With a growing number of large firms linked to each other through clearing and settlement systems, capital markets activities, and counterparty risks, it is becoming more difficult to avoid supporting such entities during crisis periods. In fact, we are rapidly creating an environment in which the investors, creditors and managers at such institutions take it for granted that they will have this added measure of protection when taking risk.

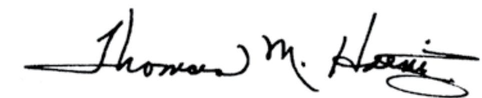
There are no easy answers in dealing with this "too-big-to-fail" issue, but we need to take some strong steps if we are to restore the proper balance between financial risk and return and make market discipline effective. But we must be certain that whenever a bailout cannot be avoided, it should follow that public authorities assume senior positions with respect to stockholders and other creditors at these "too-big-to-fail" institutions.

Conclusion

The Federal Reserve, as the nation's central bank, has responsibility and accountability for overall financial stability. It has been given the tools of authority in monetary policy, and regulatory and payments system oversight in a decentralized structure insulated from politics to achieve its mission. Doing what must be done to facilitate financial stability has always been the independent Federal Reserve System's role. It will be difficult. One has to look no further than recent news media headlines about the strong opposition to the proposed regulatory changes in the mortgage industry that I just mentioned to know this is true. But this environment is not much different today than at the Federal Reserve's founding. Thus, as we take on these new challenges, I'll leave you with this quote from 1930 to illustrate my point. It is from Paul Warburg, who was appointed a member of the first Federal Reserve Board by President Woodrow Wilson:

"In a country whose idol is prosperity, any attempt to tamper with conditions in which easy profits are made and people are happy, is strongly resented. It is a desperately unpopular undertaking to dare to sound a discordant note of warning in an atmosphere of cheer, even though one might be able to forecast with certainty that the ice, on which the mad dance was going on, was bound to break. Even if one succeeded in driving the frolicking crowd ashore before the ice cracked, there would have been protests that the cover was strong enough and that no disaster would have occurred if only the situation had been left alone."

There are many challenges ahead, many choices to make. Some I suspect will be desperately unpopular.



THOMAS M. HOENIG, PRESIDENT
FEDERAL RESERVE BANK OF KANSAS CITY

Changing structure

of rural banking markets

Bill Docking, chairman and CEO of Union State Bank in Kansas, says his merger resulted in better services for customers.

PHOTO BY BOB GREENSPAN

Two small towns in south central Kansas, equal in size and just 12 miles apart, are connected by a four-lane highway that's well-traveled by those who live in one and work in the other—and want to be able to do their banking in both. That's where Docking Bancshares Inc. built its bridge.

In 2006, the Docking company acquired a bank in Winfield to merge with its longtime family-owned bank in Arkansas City. The merged bank—called Union State Bank—now has six locations in Cowley County. It is the county's largest bank corporation in terms of deposits and market share.

"We have added value … because of the merger," says Bill Docking, chairman and CEO of Union State Bank. "We were able to reinvent the combined bank. It allowed us to make systemic improvements across the board."

More locations, expanded services and new amenities, such as drive-up windows and ATMs, mean convenience and ease for customers, Docking says, not to mention the operational and other business benefits for the bank itself. New technology means banking has a higher cost than in the past.

"I think it (bank acquisition) is a clear trend, especially in areas with a declining population," says Docking, adding that Cowley County's population has not decreased, but because of the county's characteristics, consolidation "made good business sense."

Docking Bancshares also recently acquired another bank to merge with one it owned, both just across the border in Guymon, Okla. The Federal Reserve reviewed the Cowley County and Guymon acquisitions in Kansas and Oklahoma to ensure the Docking company wasn't violating antitrust laws in place to prevent monopolies.

Acquisitions, as well as technological advances, financial innovations, deregulation and demographic changes, have led to fewer banking organizations in the United States—a decline of nearly 50 percent in the past 20 years, although the number of actual bank offices has increased.

While banking organizations are evolving, they still face the same antitrust restrictions from decades ago, say Jim Harvey and Forest Myers of the Federal Reserve Bank of Kansas City. The two policy economists recently

PHOTO BY BOB GREENSPAN

UNION STATE BANK IN ARKANSAS CITY, KAN., recently acquired a bank in the nearby town of Winfield. It can be difficult for banks to expand in small rural communities; restrictions may prevent local growth.

researched changing market structure and bank performance in rural banking markets. They compared the relationship between market concentration and bank performance; looked at changes in that relationship during a 20-year period (1985-2005); and determined possible implications for the evaluation of mergers in small communities, as well as for broader antitrust policy.

Traditional antitrust analysis that focuses on the concentration in narrowly defined markets may no longer reflect marketplace realities. This is particularly important for banks wanting to merge in rural markets that, by their nature, tend to be highly concentrated, Harvey and Myers say.

"The traditional concept of a local banking market may have eroded and our antitrust methodology may need to be revisited," Harvey says. "Many of the local markets that are most constrained by antitrust concerns are small rural areas, where in-market mergers may be the most practical strategy for growth, and even survival."

The evolution

"Banking has changed," Myers says.

Legal and regulatory changes have allowed large banks to enter local communities across the country. Technology has reduced the cost of managing operations from a distance for banks, and reduced the cost of serving customers outside of their communities.

Still, it can be difficult for banks to expand in small rural communities where restrictions may prevent local growth. Mergers raise the question of banking monopolies, which are prevented by the nation's antitrust laws—in place to ensure customers receive the best

What characteristics define rural banking?

In general, rural markets have a small number of deposits and are slow-growing. They are served by both large and small banks, and are highly concentrated. They have shown little structural change through time and their market concentration and the number of competitors are not significantly different from those 20 years ago.

When analyzing the impact mergers might have on banks with offices in the same marketplace, the banking agencies look for a geographic area where the effect of a merger will be direct and immediate, say Jim Harvey and Forest Myers, policy economists with the Federal Reserve Bank of Kansas City. In rural areas, the banking agencies often start with the county as an approximation of the banking market.

Harvey and Myers focused their research on rural counties because these areas tend to be highly concentrated and merger transactions within them are more likely to present antitrust issues. They identified a group of rural counties somewhat isolated from a large population, finding 885 non-metro counties (28 percent of all counties nationwide as of 2003), as well as competitors in the markets and their shares of market activity.

There are several notable characteristics during the 1985-2005 period:

- The structural characteristics of the markets remained constant—the average number of banking organizations grew very little and the total number of competitors fell slightly.
- Market concentration remained steady.
- Few rural markets are true monopolies—about 12 percent have only one competitor.
- More than 62 percent of the markets contain at least one large banking organization (assets of more than $1 billion), which was not the case 20 years ago. Now, large out-of-market organizations have branch offices in these markets.
- The population of these markets has grown slowly, if at all—just 1.7 percent on average, compared to 24 percent nationwide. For many of these markets, the population has declined during the last 20 years.
- Bank deposits also have grown slowly, with a compound annual growth rate of 2.7 percent. The entire banking system grew 75 percent faster.

"The structural characteristics of these markets coupled with the population and deposit sizes have several implications," Harvey says. "They represent constraints on the possible increase of banks in the market, and show there is little opportunity for growth."

The stable structural characteristics have implications as well. High concentration of traditional measures suggests banks in these markets should be able to use their market power to generate better performance. This would mean competitors would view the markets favorably and outside entry would occur.

"However, the average number of competitors and the level of market concentration have remained constant during the past 20 years," Myers says. "This suggests these markets are not particularly attractive to outside entrants and may not be generating excessive profits."

Antitrust review: Protecting against monopolies

The nation's antitrust laws, as incorporated into banking laws, make it illegal for transactions that would create a banking monopoly. As a result, federal banking agencies review bank mergers and changes of ownership for possible antitrust issues. The Federal Reserve reviews transactions involving bank holding companies as well.

In their reviews, agencies use Department of Justice merger guidelines. Banking transactions that meet the criteria receive little review, while those that don't will receive more analysis. This may require Federal Reserve staff to conduct interviews or make on-site visits, says Forest Myers, a policy economist with the Federal Reserve Bank of Kansas City, who often works with bankers on their acquisition applications. This process can include:

- determining a bank's competitors;
- noting customers' commuting patterns and economic interaction with local employers, retailers, chambers of commerce, bankers and others;
- surveying households and small businesses to determine where they bank and what alternative banking services are available;
- and considering any special factors or circumstances.

The review process determines what area and who in that area are affected by the transaction.

"The willingness of people to travel, geographic impediments, employment opportunities, shopping alternatives, historic rivalries among towns and aggressiveness of competitors may all influence a market's geographic dimensions," Myers says. "All of these elements must be considered in determining if a transaction raises competitive concerns. If it does, the transaction may not be permitted."

For more information, see Banking Structure Resources at www.KansasCityFed.org/TEN.

services at the lowest cost. As a regulator, the Federal Reserve protects consumers by maintaining competitive banking markets, Myers says.

However, changes in bank branching laws, and the business of banking since the early 1980s may have eroded the traditional geographic market. Even in somewhat isolated, rural markets, customers have a plethora of choices. The possibility of entry by out-of-market firms is significantly higher now. But, the makeup of these particular markets has remained almost unchanged, suggesting they aren't particularly attractive to newcomers, Myers says.

"The very smallness of the banks and the markets where they operate is an impediment to in-market expansion by these banks," he says.

As a result, the market power that typically goes along with market concentration likely has dissipated. This could prompt the rethinking of criteria used to judge the impact of market concentration, Harvey and Myers say. It would open doors that allow banks to seek in-market mergers and increase their ability to compete effectively with larger out-of-market firms.

Effects on geographic markets

Banking laws require the review of banks' ownership and changes of control. The goal of the review is to assess the effects on banking market concentration, and whether the transaction is consistent with merger guidelines established by the Department of Justice, Harvey says.

"This is predicated on the belief that market structure, which is the number and size distribution of competitors in a market, affects competitor behavior, and ultimately competitor performance," he says. "Fewer competitors mean fewer options for customers."

Defining a market's geographic boundaries is necessary to determine the number of sellers in the market and the customers they serve. In the past, both the high cost of conducting banking over long distances and the restrictions on branching resulted in primarily local banking services. However, these barriers were broken down by personal computers and high-speed, low-cost communications, which now let customers access banking services beyond their immediate location and allow financial institutions to serve more distant customers. Remote deposits, online banking and ATMs also made this feasible. Finally, changes in branching laws have opened markets to large numbers of potential competitors.

"All of these factors force more vigorous local competition for customers' business," Harvey says. "The walls that once afforded banks a measure of protection from competition have become more porous. Even remotely located banks in rural areas may feel increased competitive pressure."

> "Fewer competitors mean fewer options for customers."

In their research, Harvey and Myers focused on banks that operate in a single county to attribute differences in performances to differences in market structure. They used five-year averages, beginning in 1981-1985 through 2001-2005, in their analysis to help reduce the effects of events not representative of bank performance, such as a drought.

Their findings show:

- The number of banks operating in rural markets declined significantly—nearly 65 percent from 1985 to 2005.
- There were few changes in the performance of these banks. Earnings and other financial variables were roughly the same as those of small banks during the same period. Growth was quite slow and barely kept pace with inflation—average asset size went from $26.9 million in 1985 to $55.8 million in 2005.
- Banks in more concentrated markets were capable of increasing interest rates on loans and/or decreasing interest rates paid on liabilities relative to banks in less-concentrated markets, especially in the earliest periods.
- The relationship between market concentration and performance weakened substantially in later periods and virtually disappeared from 2000-2005.

These findings suggest that even in isolated banking markets, concentration may be less important than it once was.

"There may be a need to stretch limits set in the Department of Justice guidelines, knowing that concentration measures may no longer capture the full extent of market competition," Myers says.

Bill Docking, of Docking Bancshares, agrees. In some cases, market designations can be overly restrictive or "out of touch" with marketplace realities, he says. Re-evaluating the way concentration is measured is beneficial to banks and their customers.

"I've never heard anyone in Guymon, Arkansas City or Winfield express concern about lack of competition among financial service providers," Docking says.

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BY BRYE STEEVES, SENIOR WRITER

FURTHER RESOURCES

"THE CHANGING INFLUENCE OF MARKET STRUCTURE ON PERFORMANCE IN RURAL BANKING MARKETS 1985 THROUGH 2005"
By James Harvey and Forest Myers
www.KansasCityFed.org/TEN

COMMENTS/QUESTIONS are welcome and should be sent to teneditors@kc.frb.org.

Feeding high prices

A number of factors are driving food price inflation

PHOTOS BY GARY BARBER

After the number of hungry little mouths in the Sturgill household doubled, the family assumed their grocery bill would, too. Instead, it nearly tripled. Yes, the family buys more food, but what they've always eaten now costs significantly more.

Back in 2002, when milk was just a dollar a gallon and Bobby and Debbie Sturgill had two children, their grocery bill was around $300 a month. Today, milk is usually more than $3 a gallon and, with four children and a new baby, groceries are about $800 a month.

"Bread, cereal, eggs have all gone up significantly," says Debbie, 33, who maintains the family's budget. "Even apples are getting really expensive."

Living in western Missouri, Debbie first noticed significant increases in almost every aisle of the grocery store about a year ago, which, according to data, is when soaring food prices had the highest gains nationwide in nearly two decades. In 2007, food price inflation rose twice as fast as overall inflation, with prices increasing 4 percent above levels from the year prior. A 2.5 percent increase is the norm most years, according to federal data.

Another sharp gain is expected this year, says Jason Henderson, an economist and the Omaha Branch executive of the Federal Reserve Bank of Kansas City. He recently researched factors driving food price inflation.

Henderson says more expensive grocery bills and restaurant tabs are the result of several factors, including:

- larger populations and larger incomes: people are eating more meat, which means more grain is needed to raise livestock;
- biofuels: ethanol and other renewable fuels mean fewer crops for food use;
- weather: droughts devastated Australian crops last year as did other conditions in Europe;
- weak dollar: the low value of currency buys less overseas and sends more food overseas;
- high input costs: rising labor and energy expenses affect every aspect of food, from fertilizer to packaging.

"Today's momentum in food prices may be signaling a new era of even higher food prices in the future," Henderson says. "Keeping food prices in check will depend on whether agriculture can increase supplies. With global food demand projected to rise, the agriculture sector will be tested."

THE INCREASING COSTS OF INGREDIENTS—especially cheese, meat and flour—has led to higher prices for customers of Wheat State Pizza, a Kansas-based franchise. Most pizzas are about a dollar more and chicken wings, for example, are 50 cents more. However, the shop in Lawrence, Kan., hasn't seen a slowdown in business, making anywhere from 150 to 400 pizzas a day.

Explaining the hike

Increases in food prices were seen across the board in the food industry, Henderson's research shows.

Some of the largest gains were in meat and dairy:

•Dairy prices rose 7.4 percent in 2007 after declining the year before. Strong export demand for dried milk underpinned overall dairy prices.

•Poultry and pork prices spiked after falling in 2006.

•Beef price increases were the result of robust demand.

•Fish and seafood prices were steady.

Crop-based food products also saw rapid gains:

•Cereal and bakery product prices jumped 4.3 percent, after three years of increases.

•Fat and oil product prices increased almost 3 percent as a result of strong national and international demand.

•Fruit and vegetable price gains eased after rebounding from freeze damage in 2006.

•Processed fruit and vegetable prices have inflated, which is a reflection of higher processing costs.

This year, the highest prices—with upwards of a 5 percent increase—are predicted for cereal and bakery products, and fats and oils. Meat, poultry, fish and dairy products are anticipated to increase less than 3 percent.

Marketing costs are in large part driving food prices. This cost is the difference between what farmers receive and what the consumers spend at the grocery store or restaurant. These costs have risen significantly during the past several decades, biting into a larger share of the retail food dollar. In 1950, marketing costs made up 59 percent of total retail food costs. Today, these costs make up 80 percent, mostly as a result of rising labor and energy costs.

Labor costs are the most expensive component of processed and prepared foods. These costs have risen as people consume more of these types of food, as well as food eaten away from home. Additionally, food manufacturers and food service firms are increasingly paying employees higher wages, especially as minimum wage increases take effect.

Energy prices also are boosting food prices by raising the costs of processing, manufacturing and transporting products, more so as oil exceeds $100 per barrel and gasoline rises above $3 a gallon.

"In the past, food prices have surged during times of high crude oil prices," Henderson says. "Research shows energy prices are quickly passed on to food, with these prices rising half a percent for every 1 percent increase in energy prices. However, the volatility of energy markets makes the impact on food prices uncertain."

Farm commodities have remained stable with the average corn price from 2000 to 2005 equaling the price farmers received in the 1970s. Although their share of retail food prices has diminished, commodities still account for a substantial part of the retail food dollar. This does, however, vary by food type—commodities represent a smaller percentage of retail costs for foods requiring more processing, packaging or advertising. For example, farmers receive 19 cents from every dollar spent on a bag of wheat flour, but just 4 cents from every dollar spent on a box of corn flakes cereal, according to the USDA.

Dining out

Not too long ago, Ryan Murphy noticed the weekly delivery of flour to Wheat State Pizza restaurants was heftier than before. The key ingredient to the trademark crust is still in 50-pound bags—it's the bill that hit Murphy like a ton of bricks.

"It's gone from $10 a bag to $30," says Murphy, who is president of the Kansas-based franchise, adding that higher wheat prices could mean an increase of as much as $400 a month for flour. The higher costs of other ingredients—specifically meat, cheese and vegetables—and the increased cost of labor also influence the bottom line, he says.

"It's affected our restaurants," Murphy says. "That has to be passed to the customer, and that's the big fear of businesses."

As a result, Wheat State raised the price of pizzas about a dollar, but Murphy isn't worried about losing customers, or worse, closing shops. In addition to the 10 regional restaurants opened since 2004, at least two more eateries will open by the end of the year.

The convenience and ease of dining out has busy families lining up at drive-thru windows and filling restaurant booths, where they are likely to see price increases, too.

"People are eating more processed foods and consuming more food away from home," Henderson says. "Processed foods and restaurant meals have higher marketing costs as do packaged foods, contributing to lower farm costs per retail food dollar."

From the farm

The price of wheat has more than tripled from a year ago, while both corn and soybeans are trading at about double the price from the year prior. On the heels of planting the most acres of corn since World War II, U.S. farmers plan to plant less corn and more soybeans this year, according to a USDA prospective planting report. Ethanol demand had prompted farmers to forgo soybeans for corn in recent years. This shift back to soybeans could push already-high corn prices even higher. More expensive livestock feed and corn-based products mean even higher prices for everything from meat to corn flakes cereal.

"Nobody's seen prices like these, ever," says Royce Schaneman, executive director of the Nebraska Wheat Board. "We've hit historic high prices. … It won't last."

The Nebraska Wheat Board promotes wheat breeding research and consumer education, among other related efforts, to ensure profitability for producers.

After rising sharply in the 1970s,

commodity prices had been relatively flat, according to Henderson's research. The average prices of corn, wheat, soybeans, pork, beef and milk from 2000 to 2005 have been equal to the average prices during the 1970s. Schaneman says today's soaring prices don't mean that producers are cashing in. Some were able to sell significant amounts of their wheat crops early at high prices, but most sell at harvest time when the supply is abundant and prices are lower.

The cost of production bites into producers' profits, which are typically low for packaged and processed foods because the portion of wheat actually in these items is small. For example, only about 5 to 6 cents from the cost of a loaf of bread goes back to the farmer, Schaneman says. The price of these commodities is small compared to their processing costs, such as transportation.

"The United States is used to a cheap, reliable food supply," Schaneman says. "To have this safe, abundant food supply, we've got to pay for it. And that's what we're doing now."

A new era of high prices?

Coupons and in-store specials add a little relief to the food budget for the seven-member Sturgill family. They try to leave expensive packaged items on the store shelves; Debbie makes baked goods from scratch; the family eats all its leftovers and only dines out on special occasions—even McDonald's or pizza for everyone can cost $30.

One of Debbie's biggest concerns is not sacrificing the family's nutrition in an effort to lower the grocery bill. So this spring, the Sturgills planted a small vegetable garden to supplement fresh foods bought from the store. Regardless of price, though, Debbie knows there are items they have to purchase, such as milk, eggs and fruit.

"It's extremely challenging," she says. "I think that we have to cut back, but there's not too much we can trim."

There's just not a lot consumers can do in response to high food prices, says Ephraim Leibtag, an economist with the Food Markets Branch of the USDA.

"Food overall is like gas overall," Leibtag says. Consumers notice price hikes, complain, but don't change their behavior much.

While consumers likely won't eat less food, there may be some trade-offs, such as eating fast food rather than at a sit-down restaurant, or substituting a cheaper item for a more expensive one, such as chicken in lieu of beef, at the grocery store. But because all food sectors are more expensive, these trade-offs likely will be limited, Leibtag says.

To compensate, "other things are going to be cut out that aren't necessary," Leibtag says. "And that's a lot harder for lower-income households."

The world's most poor are already in crisis mode. In the past year, food shortages have caused uprisings in Haiti, Pakistan and several countries in Africa.

IN AN EFFORT TO EASE THE FAMILY'S FOOD BUDGET, Debbie Sturgill plants a small garden in the backyard of their Missouri home with the help of her three oldest children, Joshua, Elizabeth and Christine. The seven family members have seen their grocery bill rise significantly in recent years.

For families everywhere, today's higher food costs may be the new norm, Henderson says. High demand for farm commodities could overrun existing production capabilities, which strains food supplies and boosts prices. Additionally, population growth (up nearly 2 billion from a decade ago) and rising incomes are changing food consumption worldwide, in effect boosting the demand, which supports these higher prices.

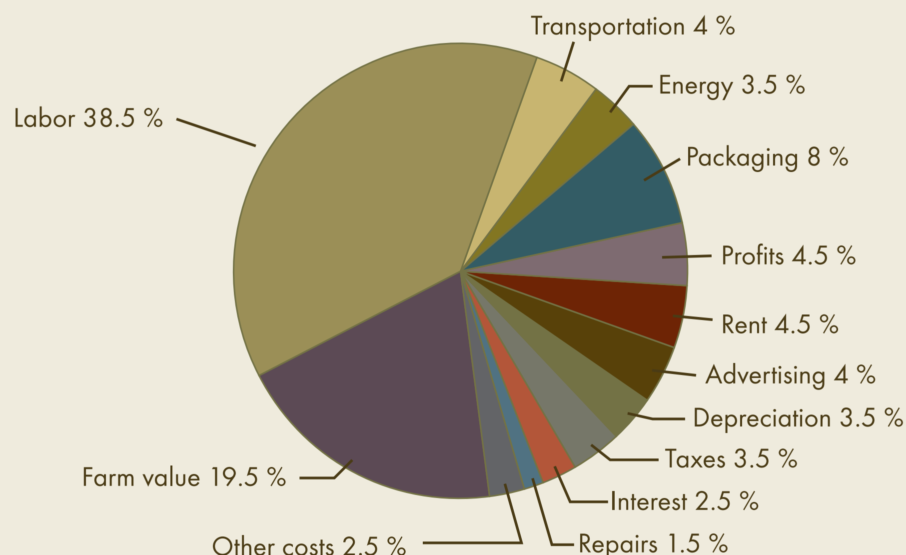
Meanwhile, nonfood use of crops, such as biofuels, is affecting global crop inventories, which are expected to drop to historic lows this year. Droughts worldwide also are trimming supplies.

Boosting agricultural productivity may be the best option for expanding the global food supply, but environmental concerns, water access, transportation infrastructure, financing and other issues could limit crop potential. These issues may be offset by evolving technology, which historically has helped farmers meet rising demand.

"To meet growing demand, agriculture will need to put more acres to the plow," Henderson says. "But, as in the past, stronger agricultural productivity will be needed to keep higher food price inflation at bay."

BY BRYE STEEVES, SENIOR WRITER

Components of retail food costs



Source: USDA

FURTHER RESOURCES

"WHAT IS DRIVING FOOD PRICE INFLATION?"
By Jason Henderson
www.KansasCityFed.org/TEN

COMMENTS/QUESTIONS are welcome and should be sent to teneditors@kc.frb.org.

Economic FORCE

DEFENSE SPENDING HAS SIGNIFICANT PRESENCE IN THE REGION

It was Eddye Moini's first job out of college as a finance officer that brought her and her new husband, Hossein, to Lawton, Okla., 26 years ago—and it was the Army that kept the couple here decades after her military commitment was up.

"I own four businesses in town and they are all affected by Fort Sill," Hossein Moini says of their travel agency and three eateries.

Whether it's crowds of Army personnel grabbing lunch at Gandolfo's New York-style deli near the main gates, or a deployed soldier e-mailing Adventure Travel to help plan a post-homecoming family vacation, Hossein Moini acknowledges, "Fort Sill is a huge piece of the business in Lawton."

The city of Lawton, about 90 miles southwest of Oklahoma City near the Texas border, has seen its population grow in the last half century from 35,000 to 110,000 due in large part to Fort Sill. When the final waves of the Base Realignment and Closure (BRAC) Commission's mandates take place in the coming years, the influx of soldiers will increase the city's population by an estimated 10 percent, according to the chamber of commerce. With this boost, Fort Sill's regional economic impact likely will tip past $2 billion, the chamber predicts.

PHOTO BY GARY BARBER

THE FLEET OF B-2 "STEALTH" BOMBERS are housed at Whiteman Air Force Base in Knob Noster, Mo., along with other aircraft. The base has a $529 million impact on its surrounding area.

THE MAJORITY OF THE PATRONS IN GANDOLFO'S DELI IN LAWTON, OKLA., are from the nearby Army post. "We get a lot of soldiers," says manager Jeri Anderson. "Fort Sill is very good to us." There are about 16,000 military personnel stationed there, with more on the way as the final waves of the nationwide realignments take place in the coming years.

"There's nothing that comes close to rivaling that," says Dana Davis, president of the Lawton-Fort Sill Chamber of Commerce.

Lawton is just one of many communities in the region heavily affected by federal defense spending.

"The military has long had an important presence in the region's economy," says Chad Wilkerson, an economist and Branch executive at the Federal Reserve Bank of Kansas City's Branch in Oklahoma City.

Wilkerson and Megan Williams, an associate economist also at the Oklahoma City Branch, researched how the recent rise in national defense spending is affecting the Tenth Federal Reserve District's economy. The District includes western Missouri, Nebraska, Kansas, Oklahoma, Wyoming, Colorado and northern New Mexico.

National defense accounts for a larger share of the District's economy than in the nation. In fact, only two states in the District, Nebraska and Wyoming, have a smaller defense presence than the country as a whole. However, the defense sector has grown less in this region than in the nation since the buildup began after the 2001 terrorist attacks. This likely can be attributed to more personnel and base-related activity that are concentrated in the District, which haven't grown as much as the defense contracting sector elsewhere.

"The ongoing national defense buildup probably will help the District economy more in the long run than in the short run," Williams says. "The region is well positioned for future expansion of defense activity."

Because defense spending in the District tends to rise less than the nation during massive national defense buildups, and fall less during cutbacks, the defense sector could potentially have a more stabilizing effect with fewer shocks to the economy than it does in other regions of the country.

"In the years and decades ahead," Wilkerson says, "defense activity is likely to become increasingly concentrated in the District, providing an overall boost to regional economic activity."

> "We certainly have a dependence on the military."

It's not hard to find folks in Lawton who know that.

Says Gandolfo's manager, Jeri Anderson, "As Fort Sill goes, so do we."

Defense and the economy

Since the United States entered World War II in late 1941, defense spending has played an important role in the nation's economy. Defense spending rose from 2 percent of the country's gross domestic product (GDP) to more than 33 percent during WWII, effectively ending the Great Depression. The share subsequently rose and fell, and since 2001, has been increasing rapidly—about twice the rate of overall national economic activity—with no signs of slowing in the near future.

National defense spending now accounts for nearly 5 percent of GDP, which is the value of all goods and services produced. In 2007, this equated to more than $650 billion, which greatly exceeds that of any other country, Williams says.

Research is mixed on whether defense spending has a positive or negative effect on national economic growth—findings are largely dependent on the time frame. There may be an economic growth boost in the short term, but other studies show high levels of defense spending to be a drag on economic growth in the long run.

"Theoretically, it could go either way," Williams says. "Defense expenditures could be used elsewhere, private or public, and be more favorable to long-term growth. But, defense spending does have obvious positive benefits, such as the development of infrastructure and technology, which are conducive to economic growth."

This recent massive increase has boosted the U.S. GDP an additional 1 percent per year during the early years of the buildup. U.S. trade and budget deficits also have risen. Research suggests this rise eventually could have a downward effect on the economy.

"Defense spending remains important to the U.S. economy," Williams says, "and while it provides a short-term boost, long-term benefits to economic growth aren't certain."

In the region

Rick Zimmerman, a sales manager at Phil Long Ford in Colorado Springs, can't help but notice a similarity among many of his customers browsing the rows of cars and trucks: They're wearing a uniform.

"One out of four, one out of five are military," Zimmerman says. "It's huge (business) for us."

Whether they're from nearby Fort Carson, Schriever or Peterson Air Force Bases or the Air Force Academy, there are roughly 45,000 members of the military living—and spending money—in Colorado Springs. Along with their families and defense-related civilian personnel, the defense sector has a multibillion-dollar

Defense in the District

Compared to the nation, the Tenth Federal Reserve District is much more heavily concentrated in personnel-related and military base defense spending, as well as in the nuclear defense-related activities conducted by the Department of Energy. While the defense presence in the District is large, it also is unique in its composition.

- The Air Force accounts for 43 percent of this area's defense personnel, compared to 23 percent nationally. The District houses 11 Air Force bases.
- The Army accounts for almost 50 percent of this area's defense personnel, which is similar to the nation's share. The District includes three of the country's 12 largest bases.
- One of the nation's five U.S. Service Academies, the Air Force Academy, is in Colorado Springs.
- The North American Aerospace Defense Command, or NORAD, which controls and surveys U.S. and Canadian airspace, is in Colorado Springs.
- Offutt Air Force Base near Omaha includes the Defense Department's weather agency.
- The Department of Energy's Los Alamos and Sandia National Laboratories, which oversee the nation's nuclear weapons stockpile and research security issues, are in northern New Mexico. New Mexico has the largest defense presence in the District.
- Tinker Air Force Base in Oklahoma City is the nation's largest and has more than 14,000 civilian Department of Defense personnel.
- Wichita, Kan., is home to the majority of the District's private defense contractors, such as Cessna Aircraft Co., Spirit Aerosystems Inc. and Raytheon Aircraft Co.
- Wyoming has the largest share of reservists and National Guard members in the District.

Source: U.S. Department of Defense

Map does not include other guard or Reserve Centers or other support facilities.

PHOTO BY JOSHUA LAWTON

BUSINESSES, SUCH AS THIS CAR DEALERSHIP in Colorado Springs, heavily rely on the 45,000 military members (and their families) who live there. The city's military presence is unique—it includes both Army and Air Force installations as well as one of the nation's five service academy schools.

impact on the local economy, say Fred Crowley and Tom Zwirlen, professors at the University of Colorado-Colorado Springs, who conduct an economic analysis annually. The city of about 600,000 is estimated to see a 2.4 percent boost to its metro employment by 2010 from the nationwide base realignment.

"I think maybe we won the lottery," Zwirlen says of the numerous military installations in Colorado Springs.

So strong is the military presence there, Crowley and Zwirlen can measure its comings and goings based on airport activity and retail sales, which spike when troops return from deployments, for example. Additional benefits include: increased enrollment at the university (Crowley and Zwirlen estimate about 10 percent of their MBA students are service members); diverse skills military spouses bring to the local workforce; military-related visitors; retirees who remain in the area; and private contractors drawn there.

Drawbacks include increased demands on schools, city services and the like. Crime rates tend to be higher in the area immediately around a base, Crowley and Zwirlen say.

"There are pluses and minuses," Zwirlen says, adding the local economy needs diversification.

"We certainly have a dependence on the military," Crowley says.

"It could potentially have a devastating effect" on the Colorado Springs economy if defense spending was reduced, Zwirlen says.

For the District, defense spending is sizable and widespread, affecting regional economies somewhat differently than the national economy, Wilkerson says. In terms of its share of GDP, defense spending in the District is about 25 percent more than in the nation. Most District states have a similar composition of defense spending, and many include some of the largest military installations in the country.

Regional effects of defense spending can

differ from each other and the nation as a whole because of differing aspects. Research shows certain types of defense spending, such as research and development, can boost an area's economic activity, especially during short periods of time.

The District's relatively large availability of land and lower labor costs are conducive to national defense needs. Political considerations play a role as well. However, the region's smaller metropolitan area population may limit the number of defense contracts awarded.

Since 2001, real defense spending in the District has risen about 4.5 percent a year compared to 7 percent nationally, while overall economic growth in the District has been slightly faster than in the nation.

Wilkerson and Williams' research shows many types of defense spending that have grown the fastest nationally are not highly concentrated in the District, while the types that are concentrated here have grown more slowly. In particular, research and development defense spending is weak in the District, but is an area that has lasting effects on a region's future economic growth.

"What drives defense activity in the region is useful in determining the role that the defense sector is likely to play in the regional economy of the future," Wilkerson says.

Future spending

"National defense is likely to continue to have an important presence in the District's economy in the coming years and decades," Wilkerson says.

The BRAC Commission recommendations about the future location of military and civilian Department of Defense personnel and bases made in 2005, and largely approved by Congress, will benefit the District. A gain of more than 11,500 personnel is expected through 2010. Additionally, the BRAC Commission estimated 8,000 new jobs for District states.

"The reasons that these areas, and others, were recommended for expansion by the BRAC Commission may provide further insights about the future of defense spending in the District," Wilkerson says.

The commission suggested Forts Riley, Sill and Carson (in Kansas, Oklahoma and Colorado, respectively) were selected, in part, because of available training land, according to its report. The commission also suggested the consolidation of some functions at an air base in Maryland to Tinker Air Force Base in Oklahoma City to reduce vulnerability near the nation's capital.

"The District's availability of open land and distance from possible future targets of terrorist attacks are viewed as assets by the BRAC Commission," Wilkerson says. "But beyond the effects of these base realignments, forecasting the future role of defense spending in this region is difficult."

The Congressional Budget Office's annual report projects generally high levels of Department of Defense spending over the long term, in addition to the ongoing military actions in Iraq and Afghanistan. Plans include purchasing new military equipment, developing weapons systems, and increasing personnel pay and benefits.

Near-term future defense spending likely will grow slightly faster outside of the District, given its minimal defense contracting. Longer-term projections, though, suggest spending on military personnel as well as operations and maintenance—areas heavily concentrated in the District—are expected to grow.

"In the years and decades ahead, defense activity is likely to become increasingly concentrated in the region," Wilkerson says, "providing an overall boost to regional economic activity."

In Lawton, there is a sense of excitement as the community prepares for the influx of defense personnel. The downtown is undergoing a major revitalization, four new apartment complexes are complete and a handful of new hotels are under construction.

Hossein and Eddye Moini hope to expand their business presence there as the Army's presence in Lawton grows.

"Definitely our success has a lot to do with Fort Sill," Hossein Moini says. "When soldiers aren't here (because of deployments or training), you can feel the difference."

> "What drives defense activity in the region is useful in determining the role that the defense sector is likely to play in the regional economy of the future."

THE COMBINED NATIONAL DEFENSE in the Tenth Federal Reserve District accounts for a larger share of the economy than in the nation. This region is well positioned for future defense growth.

PHOTO BY GARY BARBER

BY BRYE STEEVES, SENIOR WRITER

FURTHER RESOURCES

"HOW IS THE RISE IN NATIONAL DEFENSE SPENDING AFFECTING THE TENTH DISTRICT ECONOMY?"
"THE NATIONAL DEFENSE BOOST IN RURAL AMERICA"
By Chad R. Wilkerson and Megan D. Williams
www.KansasCityFed.org/TEN

COMMENTS/QUESTIONS are welcome and should be sent to teneditors@kc.frb.org.

Want to take a look inside the region's largest cash vault? Visit the Kansas City Fed's new Money Museum. For more information, go to KansasCityFed.org.

The multimillion-dollar *move*

The Kansas City Fed moves to new headquarters, transfers the contents of its vault

When construction of the Kansas City Fed's new headquarters building was complete, it of course meant packing up what was in the old building and moving it to the new one —including the contents of the vault.

But relocating hundreds of millions of dollars, even just two miles down the road, is no easy feat. It took a year of planning as well as coordination among Fed staff with U.S. Secret Service agents and officers from several units of the Kansas City Police Department.

As part of its daily business activities, the Kansas City Fed distributes and receives millions of dollars to and from Federal Reserve customers (banks and credit unions). Currency from the Bureau of Engraving and Printing and coins from the U.S. Mint are also kept in the Fed's vault before being moved into circulation.

Prior to the move, the cash inventory was reduced to the point that financial institutions were still able to get what they needed, while allowing Fed staff to move as little as possible.

The transfer of cash from one building to the other took nearly 12 hours, and the backbone of the move was intense security every step of the way. Here's how one vault was emptied and another was filled.

PHOTOS BY GARY BARBER

5 p.m.: The move started at the new building with a security sweep of the two trucks that would transport the cash. Officers, aided by dogs, combed both the new and old buildings. Meanwhile, staff moved the contents from the vault at the old building to a security dock for staging before loading the trucks.

Just before 9 p.m.: The first truck pulled into the cash dock at the old building. The second truck arrived a few minutes later. Armed agents and officers patrolled the streets outside both buildings and monitored activity in the surrounding area.

9:14 p.m.: The first cash cart was pushed onto the truck. Each cart, which had multiple locks and two numbered seals, were verified with a master list prior to being loaded on the trucks.

By 10 p.m.: Both trucks were loaded with cash carts, which can weigh as much as 1,300 pounds each.

Around 10:30 p.m.: The two trucks left the old building for the new building. They were surrounded by a motorcade of police and Secret Service cars and motorcycles, and a helicopter hovering above. Meanwhile, Secret Service agents and Fed staff gathered in a conference room inside the new building. There, they spoke by radio with agents riding in the trucks and in the caravan, while also monitoring the trucks via GPS tracking linked to a TV.

Shortly after 11 p.m.: The first of two trips was completed. Fed staff unloaded the first batch of cash carts from the trucks into processing rooms. There, the carts were retrieved by automated guided vehicles and taken into the new vault.

About 11:30 p.m.: The two trucks were back at the old building and workers began rolling the final carts on board. The final loads also contained the Tommy gun used by Fed guards in the early 1900s and a gold bar that were on display in the old building as well as the nearly 450-piece Truman Coin Collection—all

to be showcased in the Money Museum in the visitors center of the new building.

12:21 a.m.: The last cart of cash was pushed onto the truck at the old building.

12:39 a.m.: The second and final trip from the old building to the new building was made. At the new headquarters, Fed staff used the automated material handling system to fill the vault with the carts.

4 a.m.: All of the cash and coins were secured inside the vault of the new building.

BY BRYE STEEVES, SENIOR WRITER

PHOTO BY SCOTT INDERMAUR

A Grand Opening

The Kansas City Fed invites the public to new building

Regional bankers, community leaders, current and former members of the boards of directors and Federal Reserve Chairman Ben Bernanke gathered in June to commemorate the official opening of the Federal Reserve System's newest building: the headquarters for the Tenth District.

This spring, the Kansas City Fed moved from 925 Grand Blvd. just two miles south to 1 Memorial Drive to a new building with state-of-the-art technology.

In commemoration of this historic move, weeklong grand opening events included a ribbon-cutting ceremony; open houses for community members and bankers; a joint board meeting for all of the District's directors; and more.

Sculptures

The grand opening events kicked off with the installation of the larger-than-life bronze statues of the Spirits of Commerce and Industry.

The two, three-dimensional statues flank the front entrance of 1 Memorial Drive and are a tribute not only to the Kansas City Fed's purpose, but also its history.

Indiana-based artist Tuck Langland modeled these sculptures after the hand-carved stone panels that adorned the west side of the former headquarters. Artist Henry Hering designed the Spirits for that building when it opened in 1921.

The Spirits are "part of the goal to bring our tradition forward to the new building," said Tom Hoenig, president of the Kansas City Fed.

PHOTO BY GARY BARBER

Building for the future

For information on tours at the new Kansas City Fed, visit KansasCityFed.org or call (800) 333-1010 ext. 12683.

Construction of the new Kansas City Fed headquarters at 1 Memorial Drive began in the summer of 2005. Almost three years later, staff moved into the new building in phases that began in February and culminated in March with the highly secure and meticulously coordinated transfer of millions of dollars from the old vault to the new one.

The new building was designed to replace the Kansas City Fed's headquarters downtown at 925 Grand Blvd. The nearly 90-year-old facility, which was the System's oldest headquarters building, has been sold to a private developer. Fed staff had long outgrown that building, with many departments working out of leased space nearby. The new facility more effectively serves the Tenth Federal Reserve District, which includes western Missouri, Nebraska, Kansas, Oklahoma, Wyoming, Colorado and northern New Mexico.

The new building at a glance:

- The building at 1 Memorial Drive is 600,000 square feet and 14 stories tall. The former headquarters building at 925 Grand Blvd. is 367,000 square feet and 20 stories tall.
- Roughly 75 firms have been involved in the construction; more than 60 are based within the Tenth District.
- The cash vault is the region's largest with 540,000 cubic feet of storage capacity.
- There are roughly 700 security cameras.
- Limestone from the District (Cottonwood Falls, Kan.) covers the exterior.
- The elevator doors feature "10J," which is symbolic of the Tenth District (J is the tenth letter of the alphabet.)

The Spirit of Industry holds a sheaf of wheat that represents agriculture and a distaff that represents manufacturing. The Spirit of Commerce holds the torch of progress and the caduceus of Mercury, who is the god of commerce. She also wears the coat of mail, which represents security. Nearby are three jet fountains, symbolic of the Fed's mission areas: monetary policy, supervision and risk management, and financial services.

"It humanizes the building," Langland said of the Spirits. Their presence "creates a welcoming entryway."

Added Hoenig, "They are as relevant today at our new home as when they were put on the front of the 925 Grand building."

PHOTO BY GARY BARBER

Open house, dedication

The week's events included the annual meeting for all of the Tenth District's boards (Kansas City, Denver, Oklahoma City and Omaha).

KANSAS CITY FED PRESIDENT TOM HOENIG, above, addresses a crowd of 400 Kansas City-area business and community members. Below, Architect Henry Cobb, Hoenig, Deputy Board Chairman Paul DeBruce and Builder Terry Dunn cut the ribbon.

PHOTO BY SCOTT INDERMAUR

PHOTO BY SCOTT INDERMAUR

FED CHAIRMAN BEN BERNANKE addresses guests at the board dinner.

Current and former board members, along with Chairman Bernanke, gathered for dinner in the new building. The following morning, he joined state chartered Federal Reserve member bankers for breakfast and an open house. Nearly 300 bankers as well as current and former members of the board of directors then gathered for remarks by Bernanke, Hoenig and Lu Córdova, who is the Kansas City board chairman.

Bernanke said, "President Hoenig, I commend you and your staff as well as the designers and builders of this impressive structure. It will serve Kansas City and the entire Tenth District well."

"This Fed is our Fed," Córdova said. "… Let's all celebrate what we have built. We did it well and we got it right."

Later that day, a ribbon cutting signified the building's official opening.

"This building is important because the regional Federal Reserve Banks play a vital role that is often overlooked in headline discussions of the Federal Reserve," Paul DeBruce, deputy board chairman, said at the ceremony. "… The Reserve Banks were designed to connect the nation's central bank directly to the nation's banks and main streets."

FORMER CHAIRMEN OF THE KANSAS CITY FED'S Board of Directors Fred Lyons, Terry Dunn, Lu Córdova (current), Richard Bard, Jo Marie Dancik, Bob Funk, Drue Jennings, Irvine Hockaday, seated, President Tom Hoenig, former President Roger Guffey and Former Chairman Harold Andersen.

PHOTO BY SCOTT INDERMAUR

After the celebration

The Kansas City Fed continues to share its new facility and rich history with the public.

• **Money Museum tours:** Guided and self-guided tours are free and available 8:30 a.m. - 4:30 p.m. weekdays. The variety of exhibits appeals to all ages. The 3,000 square-foot museum's features include: a window into the vault and cash operations; the Truman Coin Collection; "The Fed and You" short film displayed on a 12 foot-long video wall; and exhibits to create currency and lift a gold bar.

PHOTO BY GARY BARBER

VISITORS AT THE GRAND OPENING EVENTS create their own currency at the Money Museum's rubbing station.

• **Commemorative book:** Entitled "Confidence Restored: The History of the Tenth District's Federal Reserve Bank," details the Kansas City Fed's history, starting with its creation and focusing on significant events, such as the establishment of the Branch offices. The 200-page, illustrated book was written by *TEN* editor, Tim Todd. The book is the only complete chronicle of the Kansas City Fed's history. It is available in The Vault gift shop.

• **Video:** Kansas City Public Television (KCPT) partnered with the Kansas City Fed to produce "10J: The History of the Federal Reserve Bank of Kansas City." Crews filmed locally as well as in Denver, Oklahoma City, Omaha and elsewhere around the District in order to fully represent the area. Actors created historical reenactments. The documentary debuted on KCPT in June and airs again Aug. 7 (check local listings). Segments are also featured as part of the public tour.

BY BRYE STEEVES, SENIOR WRITER

PHOTO BY SCOTT INDERMAUR

STATE BANKING COMMISSIONERS Jeff Vogel, Wyoming; Tom Thull, Kansas; Eric McClure, Missouri; Kansas City Fed Senior Vice President Esther George; President Tom Hoenig; Fed Chairman Ben Bernanke; Richard Fulkerson, Colorado; and John Munn, Nebraska.

Notes

Register now for Accounting/ Auditing Roundtables

The Supervision and Risk Management Division of the Federal Reserve Bank of Kansas City is hosting its 16th annual Accounting/ Auditing Roundtable Sept. 29 – Oct. 1. Registrations will be accepted until August 29.

The primary goal of the roundtables is to share knowledge about issues arising from accounting pronouncements, banking legislation, and examination experiences, while enhancing communication with the Fed. Arthur Lindo, deputy associate director of Accounting Policy and Disclosure at the Fed's Board of Governors, will participate in the discussions.

About 120 bankers and accounting and auditing professionals with responsibility relative to financial reporting for banking organizations are expected to attend one of the four sessions in Denver or Kansas City.

For the roundtable dates and agenda, and information about how to register, visit KansasCityFed.org/TEN. Call Lisa Aquino at (800) 333-1010 ext. 12491, or Jane Padget at ext. 12147 with questions.

PHOTO BY GARY BARBER

FIRST-GRADERS FROM WHITTIER ELEMENTARY get a financial literacy lesson from Kansas City Fed employee Gigi Wolf.

Area volunteers teach children to save

In recognition of the nationwide program Teach Children to Save Day, volunteers visited Kansas City area classrooms this spring to introduce basic money management concepts and promote saving.

For the third year, staff from the Kansas City Fed, in partnership with the Center for Economic Education at the University of Missouri-Kansas City and area banks, taught nearly 2,000 first-, second- and third-graders at 26 elementary schools. These efforts are part of the Federal Reserve's mission to promote financial and economic education.

The grade-specific, 45-minute lessons included a story, group activities and a piggy bank for each student. Lessons were developed by the Center for Economic Education and Entrepreneurship at the University of Missouri-St. Louis and the Center for Economic Education at the University of Missouri-Kansas City.

Subprime loan reports online

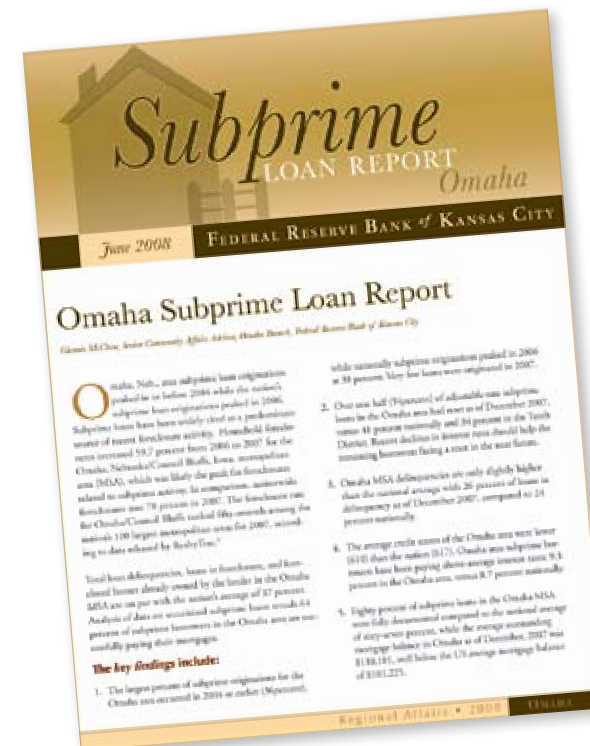
The Kansas City Fed is publishing a series of subprime loan reports for cities in the Tenth Federal Reserve District.

The reports include an analysis of data by Federal Reserve staff and comparisons with the nation for certain metro areas.

Part of the Fed's mission is spurring economic growth through community development, which includes financial education, asset building and entrepreneurship. In addition to related research, the Kansas City Fed has hosted many events focusing on housing issues throughout its region. In these efforts, Fed staff has partnered with educators, real estate agents, regulators, lenders and more.

Reports are available online for Albuquerque, Kansas City, Denver, Joplin, Omaha and Wichita. Additional cities will be the focus of forthcoming reports.

To read the reports, and sign up for e-mail notifications when a new subprime loan report is posted, visit KansasCityFed.org/TEN.



Subprime
LOAN REPORT
Omaha

June 2008

FEDERAL RESERVE BANK of KANSAS CITY

Omaha Subprime Loan Report

The key findings include:

Book translated to Chinese

A banking regulation book written by Ken Spong, a senior economist at the Kansas City Fed, is now available in Chinese.

Spong's book, "Banking Regulation: Its Purposes, Implementation and Effects," recently was translated by the China Banking Regulatory Commission (CBRC). The Chinese banking system is undergoing reform in an effort to bring in greater market oversight and efficiency; improved risk management practices; and increased private ownership of banks. The CBRC is interested in how the United States regulates its own banking system, and approached Spong, who does not speak Chinese, for permission to translate his book. He welcomed the opportunity to share this work with an even broader audience.

This is the book's first official translation, although the English-language edition is widely used in the United States and abroad for supervisory training purposes and as an educational guide on U.S. banking regulation.

"Banking Regulation: Its Purposes, Implementation and Effects" is available at KansasCityFed.org/TEN.

Notes

Traveling currency exhibit available

The Kansas City Fed is offering its traveling exhibit of historic U.S. currency to banks and depository institutions in the Tenth Federal Reserve District for temporary display.

The exhibit features currency from the Colonial period through today. It focuses on historically significant items, such as State Bank notes, and also includes silver and gold coins, Confederate notes, and Demand notes, which are often called "greenbacks."

There is no charge to host the exhibit, but institutions must have at least $5,000 in liability insurance and must pay shipping costs to transport the display to its next location. It ships in two cases, each weighing about 130 pounds. The exhibit is circular and needs a space of at least 6-feet by 6-feet to stand.

To reserve the exhibit, contact the Kansas City Fed at (800) 333-1010 ext. 12554.

Bank Anniversaries

The following banks in the Tenth District are celebrating one, five, 10 or 20 or more years as Federal Reserve members in July, August or September.

Bank	City	State	Years
Uinta County State Bank	Mountain View	Wyo.	88
Wahoo State Bank	Wahoo	Neb.	76
Gunnison B&TC	Gunnison	Colo.	68
Farmers State Bank	Stanberry	Mo.	67
Union State Bank	Clay Center	Kan.	66
Bank of Holyrood	Holyrood	Kan.	65
Farmers Bank of Lincoln	Lincoln	Mo.	63
Security State Bank	Basin	Wyo.	60
Premier Bank	Lenexa	Kan.	29
Bank of Cushing & TC	Cushing	Okla.	28
MontroseBank	Montrose	Colo.	24
America's Community Bank	Blue Springs	Mo.	10
F&M B&TC	Tulsa	Okla.	10
FirstBank of Vail	Vail	Colo.	10
High Plains Bank	Flagler	Colo.	5

Compiled By TEN Staff

COMMENTS/QUESTIONS are welcome and should be sent to teneditors@kc.frb.org.

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The Federal Reserve System

Congress created the Federal Reserve in 1913 to bring financial stability after a number of banking panics. It is the nation's third central bank. The first, established in 1791, and the second, created in 1816, were each operational for 20 years. In both cases, its charter failed to be renewed and the banks closed.

With the Federal Reserve Act, Congress sought to create a central bank the public would be more likely to support by making it "decentralized" with more local control. This new structure was designed to overcome one of the primary weaknesses of the previous central banks: public distrust of an institution that many felt could potentially be under the control of either government or special interests. The new central bank is a network of 12 regional Federal Reserve Banks, located throughout the country and under the leadership of local boards of directors, with oversight from the Board of Governors in Washington, D.C., a government agency.

The Federal Reserve is considered to be independent within government and broadly insulated from political pressures. While members of the Board of Governors are nominated by the president of the United States and confirmed by the Senate, the Federal Reserve's regional structure, including local boards of directors and advisory councils, ensures that views from a broad spectrum of the public nationwide contribute to the central bank's deliberations.

President Woodrow Wilson signed the Federal Reserve Act on Dec. 23, 1913, and the 12 regional Federal Reserve Banks opened on Nov. 16, 1914.

The Federal Reserve Bank of Kansas City

The Federal Reserve Bank of Kansas City and its Branches in Denver, Oklahoma City and Omaha serve the Tenth Federal Reserve District, which encompasses western Missouri, Nebraska, Kansas, Oklahoma, Wyoming, Colorado and northern New Mexico. As a part of the Federal Reserve System, the Bank participates in setting national monetary policy, supervising and regulating numerous commercial banks and bank holding companies, and providing check processing and other services to depository institutions.

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The views and opinions expressed in **TEN** are not necessarily those of the Federal Reserve Bank of Kansas City, the Federal Reserve System, its governors, officers or representatives.

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The Kansas City Fed's new, interactive Money Museum

just a few million reasons to visit

- Take a look inside the region's largest cash vault
- Design your own currency
- See the Truman Coin Collection
- Learn about the Fed's role in the economy

Exhibits appeal to all ages; additional resources are available for student groups and teachers. Walk-ins welcome; reservations required for guided visits. Tours are free and available 8:30 a.m.-4:30 p.m. weekdays.

For more information, visit KansasCityFed.org or call (800) 333-1010 ext. 12683.

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