

Forefront

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



Making Financial Markets Safer for Consumers

INSIDE:

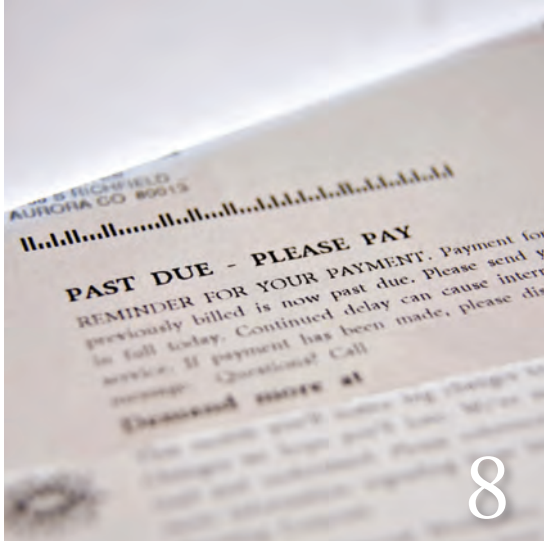
How to Rein in
Systemically Important Institutions

The Curious Case of
Cleveland's Foreclosure Rate

Q&A with Urban Economist
Matthew Kahn

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Interview with Matthew Kahn

JEFF ROGERS PHOTOGRAPHY

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Brookings Institution Press.

*Heroes and Cowards: The Social Face
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Princeton University Press.

Selected Papers:

"The Greenness of Cities:
Carbon Dioxide Emissions and Urban
Development," with Ed Glaeser. 2008.
NBER Working Paper #14238, under
revision for *Journal of Urban Economics*.
"Urban Growth and Climate Change."
2009. *Annual Review of Resource
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University of Chicago, PhD, 1993
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You could describe Matthew Kahn as a hybrid. Here is a University of Chicago-trained economist—as freshwater as they come—who now makes his home in saltwater territory at the University of California, Los Angeles. His field of emphasis is environmental and urban economics, and he spends much of his time explaining both the virtues and pitfalls of the green economy. Though he is the author of dozens of scholarly papers—with co-authors ranging from Harvard economist Ed Glaeser to Kahn's own wife, economist Dora Costa—he finds true joy in posting sometimes-whimsical missives to his blog.

Kahn is a professor at the UCLA Institute of the Environment, the Department of Economics, and the Department of Public Policy. He is also a research associate with the National Bureau of Economic Research. He has taught at Columbia, Tufts, Harvard, and Stanford. He earned his PhD in economics in 1993 from the University of Chicago. His 2006 book, *Green Cities: Urban Growth and the Environment*, has made him one of the nation's leading authorities on the subject. In July, the *Wall Street Journal* named Kahn's blog—"Environmental and Urban Economics" at greeneconomics.blogspot.com—one of the top 25 economics blogs. "UCLA's Matthew Kahn is a bright light among economists studying environmental and urban issues," the *Journal* said. "He has a breezy writing style that puts most other econobloggers to shame."

On October 1, 2009, Kahn visited Lexington, Kentucky, to present a paper at the Conference on Appalachia and the Legacy of the War on Poverty at the University of Kentucky. Francisca Richter, research economist in the Community Development Department of the Federal Reserve Bank of Cleveland, interviewed Kahn before the conference. An edited transcript follows.

Richter: *We will start with your work on green cities. To begin with, what types of cities would you say have boomed over the past 35 years?*

Kahn: Let me point to three big facts. In the United States, urban economists have noted—and everyone else has as well—that people seek out warm-weather cities. This is behind the boom of Phoenix, Las Vegas, and Dallas. Warm weather is one exogenous factor that people want. Second is a coastal city. Jordan Rappaport and Jeffrey Sachs have done some nice work documenting that the U.S. population wants to be on the coast rather than in “flyover” country. I was born in Chicago and I guess that’s part of the country they’re flying over. And finally, booming cities have been the *skilled* cities, those having more educated residents. Skill is usually measured by what percentage of adults are college graduates, and those cities with a lot of college graduates have greater wage growth and population growth than other cities.

Richter: *And how do so-called green cities fare? How would you even define green cities?*

Kahn: An example of a green city would be San Francisco, where a large chunk of its livability is from its climate. No government policy can get rid of humidity or cold winter temperatures. What goes right in San Francisco is that it has a feel of new urbanism, of having a walkable, outdoor life.

On local environmental criteria, San Francisco has clean air, clean water, no public health outbreaks. And then on global environmental criteria, while the United States has the largest carbon footprint per capita of any nation, San Francisco is one of our greener cities in terms of carbon dioxide per capita because people don’t use a lot of air conditioning there. The electricity they use is generated from natural gas-powered plants, which are cleaner than coal-fired plants. And people do use public transit there more than in

other cities. So to finally answer your question, a green city scores high on local and global environmental criteria. But a mayor would really only care about the local criteria in terms of pleasing his or her constituents.

That said, green cities are not a free lunch. What happens in many cases, such as in Marin County in San Francisco, with open space initiatives—you’re taking that land out of the housing supply. So from a simple supply and demand angle, you’re going to get higher home prices in these communities. That’s because the community has become more desirable and also you’re making it harder to build on this chunk of desirable land. Homeowners become richer but renters (and minority households are often renters) get punished by gentrification and may not be able to afford to live in their old community. Some urban economists are studying this churning—getting priced out of your own neighborhood. This has been documented in Harlem as crime has fallen in Manhattan.

Richter: *This leads into the question of how you measure the greenness of a city. The value of residents not imposing negative externalities on other places is a desirable characteristic you have just mentioned. A “GPI”—Genuine Progress Indicator—has also been put out as a measure of sustainability and greenness. I assume it’s not easy to measure greenness, but could you comment on that?*

Kahn: I teach environmental economics and I talk about green accounting. A nation like Saudi Arabia is wealthy per capita, but it has destroyed the whole place in mining and extracting these resources. Is it really a high-income society? The answer is no, because we haven’t netted out the destruction, the depreciation of natural capital, and the health damage done in the production of that income. The challenge with this GPI is that it’s a great idea in theory, but how do you operationalize it?

Economists for decades have debated this. Joseph Stiglitz released a report saying national income accounting is incomplete [because environmental effects are not recognized] but you say, OK, Nobel Laureate Stiglitz, what should we do? The report didn’t give an answer.

So let’s see if I can quickly sketch an answer. Let’s do greenhouse gas emissions because it’s easier. Nicholas Stern of the London School of Economics, Lord Stern, has been raising interest in the issue of climate change. He has argued that every ton of carbon dioxide we release causes roughly \$40 of social damage to the world. Suppose that’s true. In that case we can do the GPI calculation—if a factory in Cleveland produces \$1 million of output but also creates 50 tons of carbon dioxide, Lord Stern would say that factory’s value-added to the world economy is that \$1 million of production minus the \$40 per ton times the 50 tons. We need to net off the pollution damage but we have to be macho enough, if I could use that word, to estimate these damages. The hard part is figuring out for every extra unit of air pollution or ton of carbon dioxide, how much damage has been created.

I’m more optimistic that we can do this type of calculation for greenhouse gases than for local pollutants. Let me tell you about the challenge with air pollution. Suppose a factory in Cleveland produces some output, perhaps Twinkies, but it also produces air pollution. As an economist, if you said to me, Matt, what is the total value-added of this factory? I will of course say we need to net off pollution damages. But how are we going to do that? I would need to talk to an atmospheric chemist about how many people live near that factory. Not everybody in Cleveland will be affected by that factory. If the wind blows east, it’s only the people who live to the east of the factory will be affected.

Then we get into the next question: Who are those individuals? Are they old and asthmatic, or are they young supermen, a bunch of LeBron Jameses who can take air pollution without any damage? A bunch of LeBron Jameses can be exposed to the Twinkie factory and not suffer at all, whereas a bunch of elderly people might all die. The public health costs of the pollution would be huge, so determining the GPI indicator for measuring the environmental impact of that factory in Cleveland would require a huge amount of data. Unfortunately I think it has to be done on a case-by-case basis. Harvard researchers have estimated the social damage caused by coal-fired power plants, where they calculate how many people live near these plants and who they are in terms of their demographics and how much they are likely to suffer from the power plant's pollution.

On demographics in many major cities: What we are seeing are highly educated young people who are not yet married, without children, wanting to live downtown and people like my parents, who after their suburban days want the hipness of downtown.



Richter: This gets to the relationship between greener standards and the economic development of cities: As cities grow, they affect the environment. At earlier stages of development, the economic growth of cities could contribute to environmental degradation.

Kahn: Let me tell you a story about Los Angeles, my new home. In the 1950s, people in L.A. started to drive more and more. There were more and more people in L.A., with more and more money, driving more and more miles, but the cars did not have catalytic converters. In the United States, we only began to phase in catalytic converters starting in 1972. What an economist would say is the scale of the economic activity increased—

more and more people driving more and more cars more and more miles, and emissions per mile did not decline and this led to the horrible smog problems that Los Angeles is famous for, the orange city.

What you're referring to is an environmental Kuznets Curve. With economic development, many urban, environmental problems first get worse and then get better. In 1972 when I was six years old, I was not in L.A., but I can imagine the city was getting richer and it was choking on the pollution. Middle-class people must have said, what the heck is going on? This is not a green city. We are in the United States. Can't we do better?

Starting in 1972, there was a regime break. California got tough on demanding that emissions of driving per mile get much lower, and by the 1980s and the 1990s, smog got much better in L.A. Emissions per mile of driving were falling faster, even though the total number of miles driven was rising. More people, richer people, were driving more, but emissions per mile fell, because of the technological advance of the catalytic converter—technology offset the consumption.

Many environmentalists point to the quantity effect of capitalism, the American Dream that people want more, more, more. But people ignore the quality effect that a richer nation can have higher-quality [i.e., cleaner] products. In a nutshell, it's a race between quantity and quality that generates this inverted U with economic development—first you get pollution, but then you actually solve pollution problems with further economic development.

Richter: How would you respond to the concerns of poorer cities—they are at the first stage of development and dealing with issues of low incomes, stressed budgets, crime, under-performing schools. Are there still ways for them to pursue some green policies?

Kahn: I think this is a crucial question for cities. Your question is both about local public finance and about green cities. Let me tell you an optimistic

story. Imagine a city that, because of its ability to be green, its ability to overcome its crime problem, young urbanites feel safe downtown and want to live and work downtown. They will pay their taxes grudgingly, and the mayor will use a fair chunk of those taxes to redistribute to the urban poor in the same city. So there can be a win-win. A mayor whose focus is perhaps urban minorities might actually want to create a green city to create a revenue base in order to redistribute to constituents who he's worried about.

I believe that story. I think there is some evidence for that story. On demographics in many major cities: What we are seeing are highly educated young people who are not yet married, without children, wanting to live downtown and people like my parents, who after their suburban days want the hipness of downtown. Both of those demographic groups are living in the center city, and this creates a tax revenue source off the sales tax base and the income tax base for a center city mayor. I agree the mayor has problems. Schools have issues. There are still large pockets of urban poverty. But one way to address these issues is to build this golden goose, this tax revenue off the green, livable city, and then to engage in redistribution that the society needs.

Richter: On your blog, you noted that you can buy 100 homes in Detroit for the price of one in Westwood [where UCLA is located]. Is that a good deal?

Kahn: I started this blog because my wife wanted me to stop telling her all my ideas, and this was a cheap way to communicate with all my friends in academia. Many of them read it and then send me rude remarks. But to your question, UCLA has been suffering from high local real estate prices! A sign to economists of great quality of life is high real estate prices, but UCLA is having trouble recruiting faculty because of it. Faculty at an Ohio State or a university in Boston say, "UCLA is a great school, but I can't afford the housing nearby." I'm talking about a \$1.3 million, 2,000 square

foot house, not the Playboy mansion, that is affecting the ability of UCLA to recruit.

Then I read another webpage that Detroit homes are \$13,000 each. So my thinking was along these lines: I'm writing a new book about how climate change will affect cities' quality of life. For example, if winter becomes warmer in Cleveland and Detroit and other Midwest and Northeast cities, then by the year 2075 the current huge home price differential between Los Angeles and these cities could sharply shrink. If these cities become warmer, will Cleveland and Detroit by the year 2075 be much more desirable places? A good economist should react to that news before it is reflected in prices. So I should be selling my Westwood house and making this purchase now.

But when people commented on my piece they pointed out that most of these Detroit homes have been stripped down, no metal. You would have to invest a huge amount of money to make these livable homes. While you can buy a Detroit home for \$13,000, you cannot move into it.

Richter: *Cities with greater skills experience greater growth. So with regards to Appalachia, should efforts in this region be focused on retaining recent graduates, or on recruiting them?*

Kahn: This is an excellent and very important question. Appalachia could increase its stock of skilled people in two ways. First, if they can grow their own, such as young people who go to Appalachian State University and after graduation stay. Second, if someone goes to UCLA in Los Angeles and says to heck with this and moves to Appalachia.

But in truth, when I looked at the data, nobody outside of Appalachia who is highly skilled is moving to the region. In my opinion, Appalachia's best chance to raise its skill level is to grow its own and then get aggressive in retaining them. It's like a baseball team with a minor league farm system for growing new stars and then doesn't lose them to free agency.

If I were a mayor or governor in the states that comprise Appalachia, I think I would talk more to the 22-year-olds finishing Appalachian State University and West Virginia University, and ask them—are you staying? If they are going, what was the factor that pushed them out? Was it jobs? Was it that it's boring here? And then use the clues from that survey to design a set of policies to encourage them to stay. The challenges Appalachian cities face are: They are relatively small, not on the coast, many have cold winters, and the economy is undiversified. They have manufacturing and mining but not much “Google” activity.

So if a computer science major at Appalachian State wanted to stay in the region, what are the set of jobs he could get right now? That's the question I'd like to ask the governor. Those are the fights the governor needs to win to increase the skill base of the region.

Richter: *Small cities are often characterized by very little economic diversification. How can cities achieve economic development in that context?*

Kahn: The oldest question in urban economics is the chicken and egg riddle: Do people follow jobs or do jobs follow people? One strategy is what Berkeley and MIT economists documented with the “million dollar plant.” Enrico Moretti and Michael Greenstone have documented that rural counties that successfully recruit big manufacturing plants, like a new car factory, offer direct economic opportunities by creating new jobs and stimulating increased demand by other firms in the same county. For example, if a new car manufacturer opens, an input supplier who makes tires might locate nearby to supply these tires.

There are two different paths for achieving economic development. You can use incentives to attract new jobs to the region and hope that this attracts young people, or you can attract skilled people and if word gets

out that there is a high-quality-of-life place where the skilled want to live, then employers who want to hire them will show up. My advice for Appalachia's politicians is that they should experiment and try out both strategies.



In my opinion, Appalachia's best chance to raise its skill level is to grow its own and then get aggressive in retaining them.

I'm an honest man. I think it's important to know what you don't know. When you know that you don't know something, the answer is to experiment! Too often in the past, development economists have told poor nations do this, do that—where I think this is a case where we want to experiment and see what works using a field experiment approach.

We have evidence that poverty is declining in communities and that per capita income and employment are rising in cities and areas that are trying these various treatments, whether it is subsidizing college graduates who remain in the region or subsidizing million-dollar plants to move into a county. The key issue here is having a well-defined “control group” to determine what local poverty rates would have been if the specific policy being evaluated had not been tried.

Richter: *Pittsburgh was built as a manufacturing hub and now has transformed itself into something quite different, in fact becoming a recent economic development success story. What lessons can a city such as Cleveland learn from Pittsburgh?*

Kahn: One special thing about Pittsburgh is that both Carnegie Mellon University and the University of Pittsburgh are downtown. But I would hope that Cleveland could follow a very similar arc. I actually want to hear your views on that. I see no reason why Cleveland couldn't have the same success unless we're talking about Super Bowls!

For economic growth, you can either retain your own or attract others to move in, but you can only attract others if they have a generally favorable assessment of the city.



Richter: *Cleveland is a small-enough city that it allows one to go from one place to the next in a short period of time. Enough culture, wonderful music with the Cleveland Orchestra....*

Kahn: The United States has over 200 metro areas, and it would interest me to learn about perceptions about Cleveland for people who live in other cities. If we asked people in Orlando what they think about Cleveland, putting LeBron James aside, what would they say? Would they say it's the "mistake by the lake," or talk about the water catching on fire in 1969? If I were the Cleveland Chamber of Commerce, I think it would be worth commissioning a study to see if there's a fundamental disconnect in perceptions. Should they be buying everyone a ticket to visit Cleveland? Tourism brings people in from Kansas and allows them to experience New York, and some of those folks move in!

For economic growth, you can either retain your own or attract others to move in, but you can only attract others if they have a generally favorable assessment of the city.

Richter: *In three generations, will Americans be worse off? Specifically, I wonder about small towns in Kentucky, or about Cleveland.*

Kahn: I'm a big-time optimist. Economic growth will continue because we have the world's best universities. My own research focuses on "smaller" quality-of-life issues. I hope we can get a handle on traffic congestion. Economists have proposed road pricing, like what London did with its congestion charge. But no one is listening to us.

In terms of crime in cities, we've made great progress. Air pollution? We've made great progress. Water pollution in cities? My father now goes fishing on the Hudson River, which was disgusting 30 years ago, and he's catching fish! There are people canoeing and jogging near the river. On several dimensions we've reclaimed pieces of our cities. But I do worry about climate change in our cities, in particular how that will affect our coastal cities. But, I'm highly optimistic about our long-run quality of life.

In terms of small cities in Appalachia, I think they will find their niche. They certainly have the right incentives to do so. One question I have been asking is about the future of coal in Appalachia. When coal prices have been high, Appalachia has been doing great. But in a world of carbon pricing, as coal-based electric utilities substitute away from coal, that whole industry might collapse, which will have huge short-run costs for Appalachia. But as a green cities guy, I would argue there are long-run benefits.

Richter: *Along those lines, some people, including members of the current Administration, view climate change as an opportunity for innovation and job creation. Do you agree with that assessment?*

Kahn: I hope so, but it takes an incentive. Ninety-nine percent of economists agree that we need a carbon tax or some sort of cap-and-trade system to put a price on releasing carbon-greenhouse gas emissions. That would create all sorts of new opportunities.

This hotel we're in right now, how energy efficient is it? And if this hotel faced a carbon tax, it would have the right incentives to hire a weatherizer to take a new look at this building to see if it could use energy more efficiently. That's the type of job that would be created. Some jobs would be destroyed, such as very energy-intensive manufacturing. Certain steel activity uses a high amount of electricity. If we have coal pricing,

electricity prices will go up and some of this activity will migrate abroad. I think we need to have an honest discussion about job creation and job destruction once we introduce this carbon legislation.

Richter: *Why did you become an economist? Did you know since you were three years old that you wanted to become an economist?*

Kahn: My father had me reading the *New York Times* from an early age. I was looking for a subject that would help me think about the real world. Now, this deep recession has been a little humbling for economists. It has caused a lot of debate at lunch at UCLA! But I find on average that microeconomics is a powerful tool for understanding the world.

I can't claim to be an activist. I would love people to say that Kahn was good at understanding this transition of cities from areas that focused on industrial activity to consumer cities, where people get to play and live out their lives in a high-quality-of-life setting. To answer your question, economics, both incentive theory and the statistics that we're taught, has been a powerful tool for helping me understand the dynamics of city quality of life.

Richter: *Thank you very much.* ■



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