

COMMUNITY BANKS AND THE FUTURE OF THE KANSAS ECONOMY

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It is a pleasure for me to be here today, and I want to thank you for the opportunity to speak at your annual meeting.

The Kansas Bankers Association has played an important role in the history of the Federal Reserve Bank of Kansas City, dating back quite literally to our Bank's founding. You may have read about some of this history earlier this year in an article published in *The Kansas Banker*.

When the Federal Reserve's founders were determining locations for the nation's new Reserve Banks in 1914, the KBA was especially active in promoting Kansas City. Under the KBA's leadership, more than 1,000 Kansas bankers signed cards indicating their support for a Bank in Kansas City. It was an impressive and important showing of unity as the entire region came together for a common purpose. It was also unique. In many other areas of the country, bitter local rivalries nearly overwhelmed the individuals responsible for determining the locations of the 12 regional Banks.

The president of the KBA at that time was an Atchison, Kan. banker named Willis Bailey. Interestingly, Bailey, who was also a former Kansas governor, became a member of our Bank's first Board of Directors. He is also one of my early predecessors, serving as the president of the Federal Reserve Bank of Kansas City for 10 years starting in 1922.

Bailey and his work set the stage for a long and important relationship between our organizations that continues to this day. Over the years, many of you have participated at our conferences, economic forums and regulatory updates. We have also had a supervisory relationship with nearly all of you, at either a bank or a holding company level. Moreover, Kansas bankers, including some of you, have been important participants on our Board of Directors.

And recently, we were pleased when a group from the KBA was one of the first to tour our new headquarters, which is now under construction. We are extremely happy with progress on the project, and we look forward to next spring when we will have the once-in-a-century experience of moving into a new building. We look forward to the KBA joining us in those ceremonies.

Today, I would like to talk about an issue that is important to all of us: the Kansas economy, its future, and the potential opportunities and risks for Kansas banks. I will be more than happy to take your questions at the end of my remarks as time allows.

The economic environment

Overall, the economy is healthy, with growth accelerating to potential while unemployment is low. There are, however, a few key concerns of which you are probably well aware. One is residential housing, which might not recover as soon as some have expected, and another, of course, is high energy prices, which could push up prices on other goods and slow consumer spending.

In this economic environment, recent banking performance has been very strong. ROAs have generally been high. Credit quality has been good, although slippage is beginning to show in some portfolios.

Looking ahead, Kansas bankers face continuing challenges as the structure of the banking industry and the state economy evolve. As Kansas goes, so goes Kansas banking, and so the important questions can be framed around what opportunity will there be in the Kansas economy of the future?

What sets the Tenth District and Kansas apart?

The industrial structure of the Tenth Federal Reserve District, including that of Kansas, has changed considerably in recent decades, and it will continue to change in the years ahead. It is vital for Kansas bankers, as they think about the future of their community banks, to be prepared for whatever they encounter.

According to research by our Bank's economists, a region's ability to outperform the national economy hinges on the industries that are unique to that area. These defining industries are what can differentiate, for better or worse, a local economy from national trends. Knowing both what these industries are and how they are changing is vital for recognizing the opportunities as well as the risks.

Before we discuss the industries that most define the Kansas economy, it is important to look at the overall evolving industrial structure, both in Kansas and more broadly in the seven states of the Tenth District.

To give an idea of just how much the structure of the regional economy has changed over a long period: At the time of the 1900 Census, nearly half of all workers in the Tenth District were employed in the agriculture and mining sectors. By 2000, that share had dropped to less than 5 percent. Manufacturing's share of employment in the region has also fallen as technological advances make it possible for fewer workers to produce greater amounts of goods.

During this transformation to a more service-based economy, the industrial structure of both Kansas and the entire Tenth District has come to look somewhat more like the rest of the nation. However, it is important to note that in even with this transition, we still remain distinctly different. In a ranking of how closely states mirror the national industrial structure,

Kansas is 30th, and other states in the Tenth District are even more unique, including New Mexico, 43rd, and Oklahoma, 47th. Wyoming was the state most unlike the national economy, finishing 51st in the ranking, which also included the District of Columbia.

As you might expect, a few of the Tenth District's defining industries, or those that most differentiate our region from the rest of the country, include energy extraction and agriculture. Others that play a role include such long-standing important industries as meat packing, aircraft manufacturing, rail transportation and telecommunications.

However, in various places across the Tenth District, new industries are emerging as significant. These are industries that have achieved critical mass, they pay relatively well and they are expected to continue to grow rapidly. A few examples from various District states include software and computer systems design, medical laboratories and biosciences, and data processing and other high-tech back-office support services.

Most of the long-standing defining industries for the rest of the Tenth District play the same role in Kansas, and they will likely continue to do so for many years to come. However, I believe there are also a couple of emerging industries in the state worthy of some attention today. In order to thrive in the future, Kansas banks need to be aware of what these industries are, and what risks and opportunities they present.

One industry that still highly defines Kansas is aircraft manufacturing—centered in Wichita. This industry has been hit hard at times in recent decades with defense cutbacks, as well as the overall difficulties of the airline industry following 9/11. But the industry has performed well of late—aircraft manufacturing employment in Kansas is up 6 percent from a year ago—and the outlook is generally positive. Increases in demand for defense aerospace

production the past few years and an improving trend in demand for civilian aircraft have created solid job growth.

And demand for personal air travel in general is likely to rise relative to other forms of transportation heading forward, as real incomes rise. This should be a boon for Wichita's civilian aircraft makers, as well as their many suppliers and employees in the years to come, providing some opportunities for Kansas bankers. The industry will likely remain relatively volatile, though, presenting some lending risks as well.

Another highly defining industry in the state is wired telecommunications providers, centered primarily at the Sprint Campus in Johnson County but distributed in many ways across the state. Wired telecoms were victims of the high-tech bust of this decade, brought on by considerable overinvestment during the 1990s. While performance has improved slightly in the past couple of years and some opportunities exist as high-speed wired telecom access reaches more homes, employment remains well below pre-2001 recession levels, and many analysts project the outlook for wired telecoms to not be as solid as for wireless, cable and satellite telecommunications. Industry consolidation and strong price competition are expected to decrease telecom employment as well. But telecommunications in general will remain important to Kansas bankers, both as they make sure their own bank is up-to-speed on the latest capabilities and as they watch the extent to which the important telecom infrastructure and expertise located in Kansas can adjust to changing trends in the industry.

In addition to aircraft and telecoms, another industry that remains fundamentally important throughout the state is, of course, agriculture, in all facets of the industry. This includes input supply and processing; farming and ranching; and, increasingly, biofuels. In general, employment growth in agriculture-related industries is anticipated to be sluggish

heading forward as farming technologies and productivity continue to advance, although the recent success of biofuels may provide some boost. While risks exist regarding the long-term viability of ethanol as an economic driver, the adaptation of traditional agricultural methods and expertise to new products and services may continue to present opportunities in many parts of Kansas and thus be opportunities for Kansas banks to grow and expand as well. These might include other types of alternative energy, other high-value-added products, agri-tourism and the like.

While aircraft manufacturing, telecommunications and agriculture will, in one way or another, continue to largely define and drive the Kansas economy in the years ahead, there also are a couple of other industries emerging as significant in the state. Though, as with the state's long-standing defining industries, there are risks to relying too heavily and focusing too much attention on specific industries, these industries could serve as potential anchors for future economic growth in some areas. As such, their recent developments and trends need to be on the radar screens of Kansas bankers.

The first is biosciences, including ag product-related research and development, as well as R&D related to human health, food and pharmaceuticals and animal health. As recently at 1990, this industry had very little presence in Kansas relative to the country as a whole. But by 2005, it was more than twice as concentrated here as in the nation. It now employs thousands and has begun to blossom in several places around the state. Although it has been prominently located in Johnson County, where synergies with the Stowers Institute in Kansas City, Mo., are possible, activity has also emerged in or near most of the state's larger university towns—including Lawrence, Manhattan, Wichita and Hays. The biosciences industry pays quite well (average earnings of \$48,000 in 2005), and the outlook

heading forward is generally bright. While activity is likely to continue to center around college towns or areas with large research institutions, the economic wealth created could benefit many banks throughout the state.

In addition to biosciences, a second important emerging industry in Kansas is what is termed office administrative services, and includes relatively high-tech back-office logistics, payroll, and other types of management support and consulting services. Like biosciences, this industry is now more than twice as concentrated in Kansas as in the nation, and it pays relatively well (also ~\$48,000). Although it is also currently located primarily in Johnson County, with advancing Internet technology, portions of this work could potentially be performed in more remote areas looking for new sources of job growth. A key will be making sure these Kansas communities have access to the right kinds of telecommunications infrastructure, as well as well-educated workers, a necessity for economic growth in general.

Summary

To summarize, the Kansas economy, like the national economy and the economy of the Tenth Federal Reserve District, has changed considerably over time and will continue to change, both within its traditional industries and in new defining industries. While trends in aircraft manufacturing, telecommunications and agriculture will continue to play a sizable role in the fate of the Kansas economy heading forward, new industries such as biosciences and back-office high-tech work may present solid opportunities for communities across the state. Kansas bankers can thrive in this changing economic environment, but in order to do so, they need to be aware of trends in each of these industries and recognize the unique opportunities and risks they present for the state.