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Indiana Leadership Summit: The Role of Strong Financial Institutions in Local Growth

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I. Intro

- A. Networks Financial Institute, an initiative of Indiana State University, was established to promote research and advance public understanding of the financial services industry and to further financial education.
- One of our principal focuses is on the role of the financial services industry in promoting economic development.
 - There is a large and growing academic literature that shows that a strong financial sector contributes to more rapid economic growth See Ross Levine's review of the literature in the *Journal of Economic Literature* (1998, pp. 688-726), for example.
 - Nicola Cetorelli, an economist at the Federal Reserve Bank of New York, has provided evidence that bank competition affects the age distribution of non-financial firms, in particular, that it increases the growth of start-up firms, where job creation is most rapid, and accelerates the exit of more mature firms. See his article, "Life-Cycle Dynamics in Industrial Sectors: The Role of Banking Market Structure," Federal Reserve Bank of St. Louis *Review*, July/ August 2003, 85(4), pp. 135-48.
 - Phillip Strahan has shown that opening bank markets to competition, especially interstate banking, has increased acquisition rates, lowered concentration, boosted the asset growth rate of high earning banks, and increased real per capita income growth. See his "Real Effects of Bank Deregulation," Federal Reserve Bank of St. Louis *Review*, August 2003 85(4), pp. 111-128.
 - Economic development and its pursuit are local issues and begin at home, so it is our pleasure to sponsor this session today to promote awareness of the importance of our financial sector to meeting the requirements of the Indiana economic development initiative.
- B. The Indiana economy is improving, ...
The Federal Reserve Bank of Philadelphia coincident indicator of economic activity (based on real economic growth and employment growth) shows that Indiana has had faster growth over the past two years

than any of our neighbors. In fact, growth has been almost twice as fast as in Illinois and three times that in Michigan.

Table 1
Indiana’s economy recently has outperformed its neighbors

State	Growth rate of coincident indicator of economic performance*		Unemployment rate
	April '03- April '05	April '92- April '05	(April 2005)
Indiana	3.0%	2.9%	5.4%
Illinois	1.7	2.7	5.9
Kentucky	2.5	2.8	5.6
Michigan	1.0	2.9	7.0
Ohio	2.1	2.9	6.1

*The coincident indicator is prepared by the Federal Reserve Bank of Philadelphia; it is based on movements in the non-farm payroll employment with a trend that is statistically tied to the growth of real state product. See Theodore M. Crone, “Consistent Economic Indexes for the 50 States,” Federal Reserve Bank of Philadelphia Working Paper 02-7/R, June 2003.

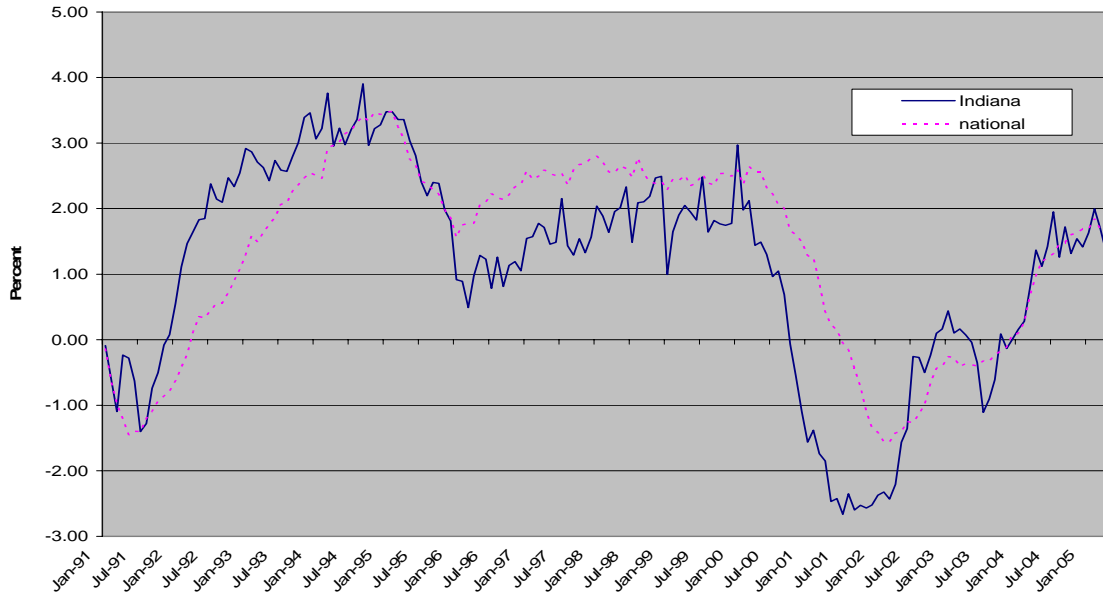
Sources: Federal Reserve Bank of Philadelphia, Bureau of Labor Statistics

The Indiana unemployment rate, at 5.4 percent in April 2005, is well below the average of neighboring states and not much different than the national average.

Indiana’s non-farm payroll employment growth, which usually lags behind the nation, matches strong US employment gains since the end of 2003.

Chart 1

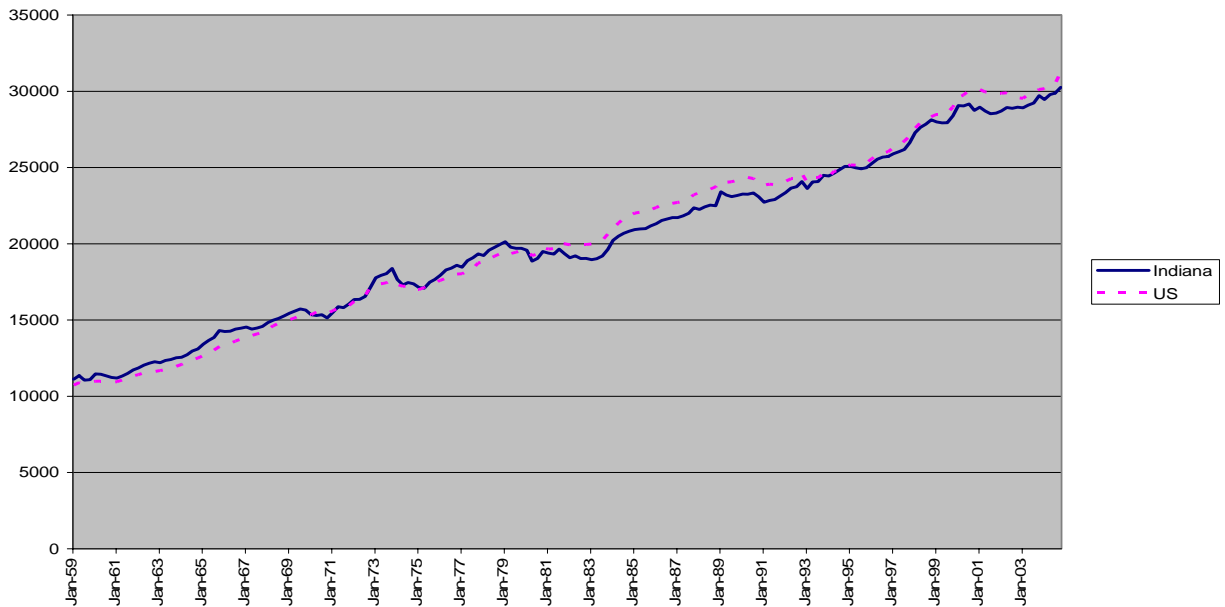
Indiana payroll employment has matched the US for the past few years (growth rate, year/year)



Real personal income per capita is high and growing: At the end of last year, real personal income per capita, according to Haver Analytics, was over \$30,000 per person (2000 prices), about 3 percent below the national average.

Chart 2

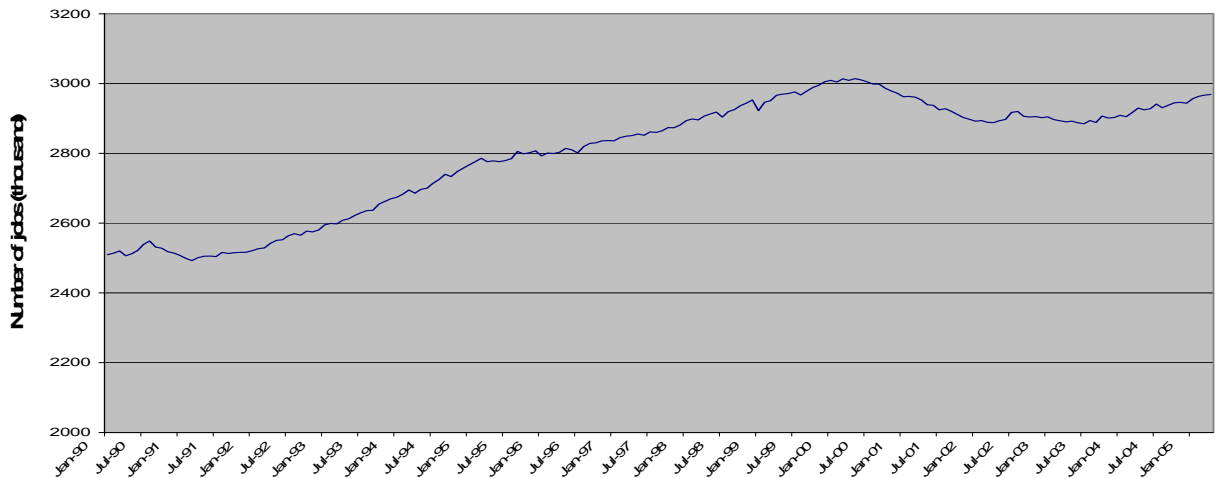
Real per capita personal income in Indiana tracks the US well



C. But the state must and can do much better, there were about 45 thousand fewer non-farm payroll jobs in Indiana this April than at the all-time peak of 3 million in May 2000.

Chart 3

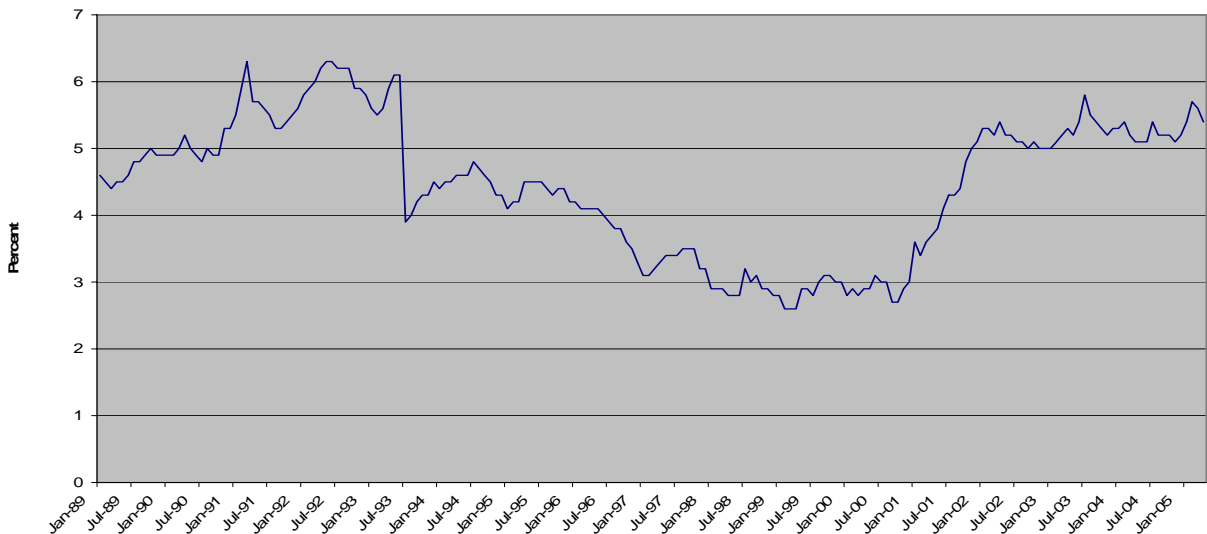
Indiana non-farm payroll employment is still below its 2000 peak of 3 million jobs



The unemployment rate has remained in a range of 5 to 5.8 percent since the recession ended in November 2001. This is far above its previous low of 2.7 percent registered in October 2000.

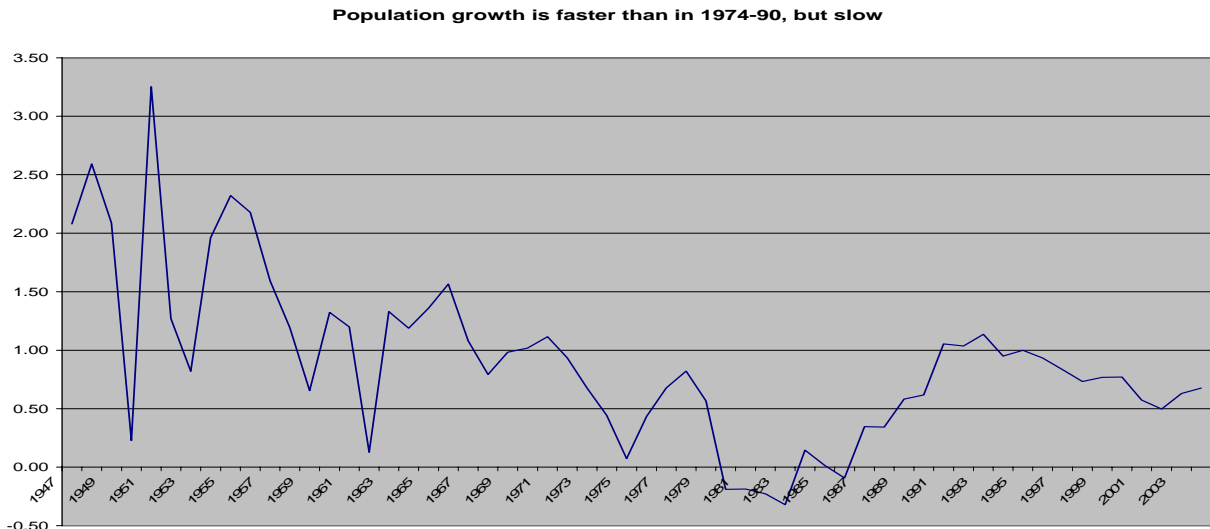
Chart 4

The Indiana unemployment rate has remained stubbornly high since the end of the last recession



While population growth has picked up from the absolute declines registered from 1979 to 1986, the growth rate (0.68 according to the Census) is still lower than the replacement rate, so Indiana's population will shrink in the future if the business climate is not made more attractive.

Chart 5



II. The Indiana Growth Initiative

- A. In 2001, the state identified three leading sectors that it will promote as leaders in state economic development—Life Sciences, Information Technology, and Advanced Manufacturing. In 2002 Agriculture was added.
- B. Michael Porter addressed the broad issue of a state's competitive advantage at this Leadership Summit in 2003. He explained Indiana's competitive advantage and the importance of these clusters.
- C. Porter's theory requires resource availability as a critical leg supporting competitive advantage—Does Indiana measure up?
- D. There has been considerable focus on upgrading the quality and quantity of the work force to meet the desired shift toward high-wage, knowledge workers.
 - There has been little work on the nexus between accelerated growth of leading sectors and capital requirements and availability.
 - We hope to begin to remedy this today.

III. The Financial Problem

- A. Growth must be financed—are the financial resources in Indiana adequate, or are they an impediment to achieving more rapid growth?
- B. The financial sector was one of the state’s leading sectors earlier, at least in Indianapolis, but in recent years it has been declining—the loss of the Bank One headquarters and those of other financial firms, especially insurance firms, and the shrinkage of Conseco are symbols, at least, of a material decline in the strength of this sector.
 - Does this decline affect the state’s growth initiative?
 - Will the consolidation of the financial sector impede the ability of other sectors to achieve rapid growth?

IV. Our Panel

- A. To address these issues, Networks Financial Institute has assembled a panel of experts on the role of financial institutions as facilitators of rapid growth and/or as leading sectors of growth.
- B. The specific context they will focus on is North Carolina, Charlotte in particular, and the Mid-Atlantic region.
- C. Charlotte offers an excellent case study because a series of bank mergers over the past 20 years has left them with the headquarters of two of the nation’s largest banks and the area had achieved rapid growth.
 - Bank of America, which moved to Charlotte after their takeover by Nations Bank in 1998, is now the largest holder of bank deposits and was ranked 5th in assets for 2004 by Institutional Investor.
 - Wachovia Bank, which moved to Charlotte from Winston-Salem in 2001 after merging with First Union Bank, was ranked 4th in assets over the same period by Institutional Investor.
- D. To speak to the experience in Charlotte, we are pleased to have Mr. Michael Mayer, Senior Vice President at Bank of America and Kenny McDonald, Vice President of Economic Development for the Charlotte Regional Partnership
 - Mr. Mayer is well-positioned to address the role of financial services firms in promoting economic development.
 - Mr. McDonald, a prominent development leader in Charlotte, will focus on Charlotte’s record of development and the role of the financial industry as a contributory factor.
- E. Dr. John Weinberg, the new Director of Research at the Federal Reserve Bank of Richmond, will close the circle. John is an expert on the financial

sector and on economic growth and will provide an overview of the connection between finance and economic development, as well as exploiting his expertise on financial development and regional economic development in his Federal Reserve district, including Charlotte, Richmond, and other cities in the mid-Atlantic states.

V. The Role of Financial Services Firms in Promoting Leading Sectors

There are numerous issues for which we hope to see some resolution today:

A. Are financial headquarters or large and strong financial sectors essential for economic growth?

- Asian emerging markets experienced “miraculous growth” without or despite very poorly developed financial markets. Indeed Jim Rohwer, in his 1995 classic *Asia Rising*, has suggested that financial sector development offered the next frontier as a leading sector to pick up the task of continuing rapid development.
- What about in Charlotte or Richmond—did a strong financial sector promote development or when that sector was retrenching or migrating elsewhere did it impede growth?
- Capturing corporate headquarters has become a strategic target for community development and this is even more true for financial headquarters. See William Testa and Thomas Klier, “The Changing Relationship between Headquarters and Cities,” *Chicago Fed Letter*, March 2005, and “Corporate Headquarters as Economic Development Targets,” in *Economic Development Review*, Winter 1988, pp. 50-6.
 - There is some dispute about the unique value of such a prize, but there is little question that headquarters can bring relative high-paying jobs and promote cluster development in business services.
 - Whether the loss of financial headquarters in insurance and banking in Indiana, especially through merger, has slowed economic growth or not remains an open question.
 - The contribution of financial headquarters and their potential effects of growth in the Mid-Atlantic States would shed some light on whether pursuit of headquarters, especially financial ones, should be a separate focus of the Indiana growth initiative.
- In 2000, Joseph Weber, Palavi Gogoi and Ann Therese Palmer, “Chicago Blues,” *BusinessWeek* (Oct. 16, pp.162-70) argued that Chicago’s growth had been damaged by loss of financial and high-tech headquarters, but Chicago political and business leaders pointed to the diversification of the economy and to the fact that mergers had actually boosted high-pay employment in Chicago by the very firms that were merging and moving headquarters. Whether this pattern fits Indiana cities is an open but useful question.

- What financial resources are required for the Indiana growth initiative?
 - Alan N. Berger and Gregory F. Udell showed in 1998 in a *Journal of Banking and Finance* piece (“The Economics of Small Business Finance: The Roles of Private Equity and Debt Markets in the Financial Growth Cycle”) that small firms (especially new ones) rely heavily on equity finance.
 - This is likely to be even more the case for small new life sciences firms that are more risky and have fewer tangible assets to serve as collateral. Eli Brewer and Hesna Genay, “Funding Small Business through the SBIC program,” Federal Reserve Bank of Chicago *Economic Perspectives* 18, 1994, pp. 22-34, show that companies without tangible assets have little access to traditional finance, including banks, and rely more on venture capital for finance.
 - Like small life sciences firms, BioAg and high-tech manufacturing start-ups are very risky, with relatively high failure rates so the availability of traditional external finance is not as critical as with traditional industry and services.
 - State programs to provide venture capital, private equity and especially seed grants such as the \$4 million fund recently announced by Bio Crossroads, are critical to break financing bottlenecks for these sectors.
- Will adequate financial resources be there? Will these resources come from existing institutions, or is rapid growth of the non-financial sector a case of “If you build it, they will come?”

VI. Implications

A. When Michael Porter spoke to this group in 2003 he emphasized that developing growth clusters or leading sectors is “a marathon, not a sprint.”

- The Indiana initiative is not a Field of Dreams. Careful planning and targeting of efforts by the state and by firms and public-private institutions will be required, must be upgrade and renewed. Dogged persistence is required to achieve success.
- The financial complement is not a Field of Dreams either. Adequate financing may or may not flow automatically to worthwhile growth initiatives without a strong financial services industry in Indiana, but considerable effort is going to be required to reverse recent trends and these trends threaten economic activity here more broadly.

B. Since 1997 the share of Indiana employment in financial activities (Finance, Insurance and Real Estate) has been declining from levels already below the national average. In 2004, the share of Indiana financial sector employment in non-farm payroll employment was 4.8 percent, below the national average

of 6.1 percent, based on data from the Bureau of Labor Statistics. Nationally, this sector has been expanding over the same period, leaving Indiana further and further behind.

- While financial services may or may not be a limiting factor for Indiana's growth initiative, this is a sector that is important in its own right as a source of national growth and for other sectors of the economy and Indiana is being left behind.
- C. While pursuing new dynamic areas of economic growth, we should not lose sight of the fact that the financial services sector is a potentially vibrant and necessary source of economic development in its own right.
- D. Charlotte may provide an example of an area where the financial sector has played the role of a leading sector. Its experience may also help us see whether it is the role of finance, or financial headquarters that matter, or more likely, that it is the development and expansion of a cluster that is critical for growth, and one if theirs just happened to be in finance. If so, then the financial sector was important for them, not so much as a source of finance, but rather because it was a dominant cluster. In that case, we should aspire to enlarge our own clusters and be more assured that financial constraints will not be a critical impediment.