Roger W Ferguson, Jr: Economic policy for our era - the Ohio experience

Remarks by Mr Roger W Ferguson Jr, Vice-Chairman of the Board of Governors of the US Federal Reserve System, at the Cleveland Millennium Conference 2000, held in Cleveland, on 11 May 2000.

*   *   *

What makes an economy world-class?

A world-class economy, as I understand the term, is an economy that successfully competes at the international level. I doubt whether there are many places in this nation that have as clear a perspective on the world economy as does northeast Ohio. One-quarter of the nation's manufacturing output is produced in an area that lies within a half day's drive from Cleveland. The region generates more than 40% of the nation's transportation equipment, 30% of its industrial machinery, and 44% of its metals - industries that make up an important part of the nation's re-energized trade sector. Consider that Ohioans exported more than $2,200 in merchandise per person in 1997. About one in four dollars of metalworking machinery production, of which this region is a major contributor, was exported. Steel mill producers in Ohio - another of your revitalized industries - have more than doubled their export volumes since the mid-1980s. And in the transportation equipment industry, the foreign-owned Honda assembly plant in Marysville, Ohio, which produced roughly half a million cars in 1998, is the largest automobile assembly plant in North America.

Today, I would like to offer some observations, from the perspective of a policymaker, on the events that have already transformed much of the national and regional economies and that are continuing to reshape business around the globe. Specifically, I want to reflect on the changing role of economic policy in our current environment of rapidly improving communications and expanding markets. To sustain the gains that this region and other regions have made in the past decade and to best ensure our continued global competitiveness, we need to fashion economic policy that, above all else, helps to facilitate communication through efficient and effective markets.

Recent economic developments

The national economy is enjoying an impressive period of prosperity. National income, after adjusting for inflation, has grown about one-third since 1991 - or by about 3½% per year. US joblessness has fallen to a level not seen in thirty years, and wealth is being created at a pace rarely seen.

Growth in this region has been even more impressive. On a per capita basis, Ohioans have seen 5% more income growth than the nation during the past eight years. Economic strength is also reflected in local labor market indicators. After many years of sub-par performance, and occasional periods of outright decline, the net growth of jobs in the region has kept pace with the exceptional US average. Even more telling has been the remarkable pattern of the local unemployment rate. After averaging more than 1 percentage point above the national average in the 1980s, joblessness in the Cleveland area fell under the US average in 1990 and has remained at, or below, the national benchmark every year since.

The recent prosperity of the region reverses the previous twelve-year period of economic decline relative to the nation in a rather dramatic way. This decline, not so flatteringly referred to by some as the "rust-bowl era", took its toll on labor and business alike. After peaking in the early-1970s, the population of the six county area surrounding and including Cuyahoga County declined annually for nearly two straight decades. But since 1990, more families have been arriving than leaving, which can be due only to this area's rejuvenated economy.

What accounts for this remarkable reversal in economic fortune? As I have said recently, on the national level, and in this region as well, the dominant force of late appears to have been a significant upshift in the rate of productivity growth. Having increased 1.6% per year from 1990 to 1995, output per hour in the non-farm business sector - a conventional measure of productivity - has risen at an annual pace of about 2.6% since 1995. Cyclical forces - such as the inability of businesses to add to their payrolls as rapidly as they would have liked in response to the rise in demand - have probably played some role in these efficiency gains. But I suspect that longer-term, structural changes, reflecting the boom in capital spending and the revolution in information technology, probably have been more important. Through this increase in productivity, our national economy has successfully prepared itself to take advantage of the rapid globalization that has characterized the current economic expansion.

While private decisions rightly deserve primacy in any discussion of the current economic climate, they were taken against the backdrop of important policy decisions. I believe that this productivity increase might not have occurred were it not for the policy adjustments that were made starting in the late 1970s and continuing even today. Furthermore, the opening of many nations' economies to our goods and services reflects, in my judgment, the fact that the world's policymakers have, in general, abandoned the economic policies that were found to be counterproductive. In the end, free trade, deregulation, sound fiscal policy, and sound monetary policy have all played a role in the strength of the US economy. These same factors are emerging as equally important in other economies.

Economic prosperity, trade and global integration

In economics, nothing is more fundamental than trade. Trade allows us individually, and as a nation, to devote our scarce resources to their most advantageous uses and then exchange our products with others to satisfy our diverse preferences. This process allows specialization, and it is what gives rise to the existence of markets. The lifeblood of trade is communication. Communication allows us to find the most profitable outlets for our products and suppliers for our needs and wants. The greater our capacity to communicate, the greater our ability to specialize, the broader our expanse of markets, and the more prosperous we become. These are not new ideas. They have been our understanding of how nations become wealthy since being described by Adam Smith more than two hundred years ago.

Today, we are experiencing a great technological revolution - a communications revolution. The proliferation of microprocessors and other innovations of the past several decades has dramatically lowered the costs of getting and transmitting information. Predictably, the new communications technology has brought with it a growth of new markets. This great expansion of markets has allowed the US economy to improve its allocation of resources by shifting them to their most internationally competitive uses. It also seems probable that these new communications technologies have brought greater openness in global markets by helping us to break down the complex and unproductive network of artificial trade barriers that characterized much of the previous century.

The role of international trade and finance in bringing renewed prosperity in the past decade to the economy of Ohio is noteworthy. From 1987 to 1997, Ohio's exports grew 60% faster than exports overall in the United States - and US export growth was very strong indeed. By 1997, the state had jumped from being the eleventh highest export state to being the seventh. And in 1996, the Cleveland area ranked twenty-third in the top seventy export communities in the nation.

This region's influence in the world economy appears to be still growing as its capital base expands. Data from the US Bureau of the Census indicate that, between 1982 and 1996, the amount of new capital added in Ohio industry grew as a share of all US capital additions. Specifically, while US industry was adding about 4¼% per year to its stock of industrial capital, Ohio was adding capital to its industry at a 5% clip.

In 1998 and 1999, slightly more than 2,100 new major projects were begun in Ohio, which puts the state among the top five states in attracting and expanding business. Moreover, about 6% of these business expansions were financed by foreign investors, of which slightly more than one-third were Asian investors and about one-half were European. The Ohio Department of Development estimates that 851 foreign-owned corporations provided only slightly less than one in twenty jobs in the state last year. Almost 75% of the foreign establishments were in the manufacturing sector, where trade opportunities have been the greatest. And the single largest regional concentration of foreign-owned businesses in the state was in Cuyahoga County, with 145 establishments.

What has this investment wrought? Today, output per hour in the region's manufacturing sector is hardly reminiscent of the economy of fifteen years ago. In industrial machinery manufacturing, for example, new capital expenditures almost doubled between 1987 and 1996, well in excess of the national average. At the same time, the productivity of Ohio industrial machinery workers jumped from more than 10% below the national average to more than 10% above the national average. This story can be repeated for a number of industries throughout the region.

The cost of growth

Economic transformation has not come without cost. Between 1977 and 1987, US industry reduced production jobs in manufacturing by 1.4 million workers. More than 200,000 - or 15% - of those jobs were in Ohio. Of those job losses, over half were centered in two industries - primary metals manufacturing and industrial machinery manufacturing - each losing more than 50,000 jobs over the decade.

In fact, the region's new competitiveness could probably not have occurred were it not for the dramatic changes this area's economy experienced in the 1980s. Is economic progress possible that does not make obsolete the methods and practices of the earlier, less efficient economy? In his 1950 book Capitalism, Socialism, and Democracy, economist Joseph Schumpeter described capitalism as a system "that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one." Schumpeter saw that economies continually bounce from one growth path to another, all the time remaking themselves. He coined the phrase "creative destruction" to describe this process.

Simply put, economies are constantly under competitive pressure to re-invent themselves. As they move toward higher levels of productivity, they necessarily make other production technologies obsolete. Schumpeter cautioned that economic policymakers who fail to appreciate the relationship between the relentless churning of the competitive environment and wealth creation will end up focusing their efforts on the methods and skills that are in decline. In so doing, they establish policies that are aimed at protecting weak, outdated technologies, and in the end, they slow the economy's march forward.

In retrospect, we can tell that some economic policies of the past century have inadvertently, or in some cases intentionally, done just that. They have had the effect of directing or misdirecting economic growth by either substituting policymakers' judgment regarding the distribution of an economy's assets for the combined wisdom of individuals or allowing markets to send false signals. In the long run, such policies were destined to fail.

The economic policies of the last century

A very broad reading of economic history reveals that policymakers in many countries during the last century attempted to manipulate trade and other forms of economic activity by altering, artificially, the *measures* of value, that is, prices. One such policy followed by some countries during the last century was known as the "beggar thy neighbor" policy, the manipulation of the exchange rate in order to boost a country's exports. Trade restrictions were also often used to protect domestic industries from imports. A final example from the international sphere is the system of global fixed exchange rates that emerged following the Second World War. To blunt market forces, fixed exchange rates were usually accompanied by capital controls that tried to manage the inflows - and more importantly the outflows - of a nation's investment funds. Ultimately, this system of global fixed exchange rates worked poorly and could not withstand the market forces that emerged in the 1970s.

In a similar spirit, some economies used taxes or other incentives to promote one industrial activity or discourage another. Obviously, the most egregious form of this policy was in planned economies. But many democratic economies, as they recovered from various wars and other national traumas, nationalized entire industries. In our society, we never found that degree of government intervention appropriate, but we did regulate some business decisions for certain industries, such as electric power distribution and airlines, attempting to overcome the "natural monopoly" or "excessive competition" characteristics perceived in these industries.

Finally, some central banks in the past engaged in policies that artificially altered the path of domestic prices in their effort to regulate their business cycles. If the monetary authority wanted more growth above trend, it lowered money-market interest rates by expanding the stock of money. Such policies were expected to bolster demand and encourage an acceleration of growth. There was the misunderstanding that somehow a long-run tradeoff existed between inflation and unemployment. But it gradually became understood that inflation eroded investor and consumer confidence and distorted behavior, both because the average of prices gave a constantly depreciating reading of the values it was supposed to represent and because relative prices provided an inaccurate reflection of comparative worth. Monetary policies that intended to create growth through the inflation of prices ended up impeding markets and reducing economic prosperity. We now know that there is no long-run tradeoff between inflation and unemployment. The US experience of the last several years has also taught us that low and stable inflation is the underpinning for sustainable growth and that sustainable growth fosters the maximum creation of jobs over time.

Emergence of the communications era

In recent decades, trade restrictions, "beggar thy neighbor" policies, and the pursuit of a supposed long-run tradeoff between inflation and unemployment have all been called into question and generally rejected. In part because of the communications revolution and the substantially reduced costs of transacting from great distances, businesses have sought more globally integrated production processes, and investors have required the development of financial instruments to facilitate their demand for international portfolio diversification. Such developments have put enormous pressure on policymakers to loosen their grip or abandon policies that led to the misallocation of resources. Tariffs have been reduced, and restrictions on the flow of goods have been eased. Controls on the flow of investment capital have been eliminated in most industrialized countries, and they are rapidly coming down in many developing nations as well. In some cases, these changes were more or less forced upon the nations that adopted them. But in many instances the policies have been liberalized because of the realization that markets allocate resources more effectively than governments.

Trade is flourishing, gaining great momentum in the ten years since the fall of the Berlin Wall. Total trade with foreigners now accounts for about one-quarter of total US national output - more than twice the share of the period between 1920 and 1970 and the largest trade share for the US economy in more than a century. Not coincidentally, the economy has been expanding at a strong and steady rate.

In addition, our economy has benefited from past actions by the government to deregulate industries. The removal of unnecessary government regulation started more than twenty years ago, during the administration of President Ford, and gathered momentum during the Carter years. It has altered the business landscape. Deregulation allowed, indeed forced, businesses to focus more clearly on a marketplace that has become more competitive, with fewer constraints and increased flexibility.

If economic policy is to play a constructive role in building a new world economy, policymakers must increasingly focus on policies that eliminate barriers to communication and allow the market to work most efficiently and effectively. They must develop approaches that do not hinder "creative destruction" but appropriately cushion its impact on workers and communities. They can encourage the information revolution by fostering policies and approaches conducive to giving investors and consumers the information they require to make informed decisions. For example, the Federal Reserve and the Basel Committee on Banking Supervision have strongly supported initiatives to improve the quality of national and international disclosure practices. Credible financial statements and other disclosures are key means for communicating a company's operating results and its overall health, as well as for making more transparent various operating activities.

Regarding monetary policy, central banks around the world are now endeavoring to provide stability to their domestic price levels. In some cases, this focus on price stability was undertaken in order to return credibility to the central bank after a period of unacceptable inflationary pressures.

The Federal Reserve, with our mandate, must also seek to facilitate the transmission of the information that the price level is meant to convey. By maintaining a stable purchasing power for money, workers and firms will more clearly see the values being attached to their opportunities and more effectively make judgments about the allocation of their resources. This is a monetary policy that does not attempt to alter the information being transmitted by the marketplace but to increase its clarity and consistency.

The increased openness of Federal Reserve decisions - reflected in announcement policies aimed at more rapid and transparent dissemination of Federal Open Market Committee decisions - also needs to be appreciated as a way to facilitate the communication to and within the marketplace in order to promote the most effective policy possible.

Policies for a communications era - a local perspective

This perspective on economic policy extends beyond the establishment of the national monetary policy that occupies much of my time. A popular bumper sticker says, "Think Globally, Act Locally." Good advice. Indeed, this simple maxim describes one of the great strengths of the Federal Reserve System. Although many tend to think of the Federal Reserve as a Washington-centric institution, it is, in fact, a structure of twelve independent regional Reserve Banks, one of which is just a few blocks from here, teamed in harness with the Board of Governors in Washington. Reserve Banks have always had an important role in channeling regional economic information into the deliberations of national economic policy. Today, they take those responsibilities a step further.

In closing, let me give a few examples of some of the local programs that are conceived in this spirit. The latest data from the US Census Bureau indicate that Cleveland and Northeast Ohio lag behind other metropolitan areas in small business growth. Linked by a desire to improve the success rate of small business, the Federal Reserve Bank of Cleveland, the US Small Business Association, and the Greater Cleveland Growth Association's Council of Smaller Enterprises in 1997 started the Access to Capital Initiative.

The purpose of the initiative was to narrow the gap between the need for and the availability of startup and expansion capital in Northeast Ohio. This collaborative, comprehensive approach to identifying gaps and barriers to capital access and developing a strategic, community-based plan to address those deficiencies has led to the creation of the Access to Capital Network. The network will be an umbrella organization that will link small and midsize businesses to the region's provider of capital and business assistance, primarily through an easy-to-use, interactive software system available free at its web site.

The Cleveland Reserve Bank has also worked with community organizations throughout the Fourth Federal Reserve District to develop resources to promote microenterprise. Microenterprises are very small businesses of less than five employees. These businesses can potentially grow and make greater contributions to the local economy if they can find the capital to do so and if they have adequate access to the technical advice that is often provided to them by community-based organizations. The Cleveland Fed provides technical expertise to these community-based organizations and helps them establish partnerships with financial institutions and other community stakeholders.

These are not policies that hope to provide preferential access to financial markets, and they are not directed at particular enterprises. Instead, they are designed to provide the forums, contacts, and skill sets necessary to form the relationships that facilitate business growth. More generally, the Federal Reserve hopes to promote a better understanding among policymakers, community leaders, and private-sector decisionmakers about the resources that support successful economic development.

Conclusion

As an economic policymaker, I believe that “Building a World-Class Economy” isn’t at all about trying to manufacture various economic outcomes. Fortunately, most policymakers have come to recognize that their role in building world-class economies is to help develop the infrastructure through which people communicate. We need to provide the public with the tools that allow them to judge value accurately and to see opportunities with the greatest clarity. Economic policy, including monetary policy, has to be an integral part of the communications revolution that is sweeping the world. These are the policies appropriate for our era.