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Federal Reserve Bank of Cleveland

Economic Policy for Our Era: The Ohio Experience

by Roger W. Ferguson, Jr.

Northeastern Ohioans can give much of the credit for their revitalized economy to the revolution in communications technology, or more precisely, to the globalization of business that the revolution has allowed. This revolution has also helped to reshape the way economic policy is being conducted here and around the world. In a recent speech in Cleveland, Roger W. Ferguson, Jr., vice chairman of the Federal Reserve Board of Governors, discussed Ohio's economic recovery and the role of economic policy in a communications era. This *Economic Commentary* is adapted from his talk at the City Club of Cleveland's Ameritech Power of Ideas 2000 Millenium Conference series on May 11.

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 many places in this nation have as clear a perspective on the world economy as northeast Ohio. One-quarter of the nation's manufacturing output is produced within a half-day's drive from Cleveland. The region generates more than 40 percent of the nation's transportation equipment, 30 percent of its industrial machinery, and 40 percent of its metals—industries that make up an important part of the nation's re-energized trade sector. Consider that about one in four dollars' worth of metalworking machinery, of which this region is a major producer, was exported. Ohio's steel producers—another of the state's 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 1999, is the largest automobile assembly plant in North America.

I would like to offer some observations, from a policymaker's perspective, on events that have already transformed national and regional economies and continue 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 progress 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, facilitates communication through efficient and effective markets.

Recent Economic Developments

The national economy is enjoying an impressive period of prosperity. U.S. income, after adjusting for inflation, has grown about one-third since 1991—or about 3½ percent annually. U.S. joblessness has fallen to a level not seen in 30 years, and wealth is being created at a pace rarely achieved.

Growth in this region has been even more impressive. On a per capita basis, northeast Ohioans saw 5 percent more income growth than the nation during the five-year period that ended in 1997. Economic strength is also reflected in local labor market indicators. After many years of subpar performance, and occasional periods of outright decline, the net growth of jobs in the region has kept pace with the exceptional U.S. average. Even more telling is 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 below the U.S. average in 1990 and has remained at or below the national benchmark every year since.

The recent prosperity of the region dramatically reverses the previous 12-year period of economic decline relative to the nation. 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

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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? On the national level, and in this region as well, the dominant force of late appears to be a significant upshift in the rate of productivity growth. Having increased 1.6 percent annually from 1990 to 1995, output per hour in the nonfarm business sector—a conventional measure of productivity—has risen at a yearly pace of about 2.6 percent since 1995. Cyclical forces—such as businesses' inability 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, have been more important. Through this increase in productivity, our national economy has successfully prepared itself to take advantage of the rapid globalization that marks the current economic expansion.

Private decisions, while they rightly deserve primacy in any discussion of the current economic climate, 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 began in the late 1970s and continue even to this day. Furthermore, the opening of many nations' economies to our goods and services reflects, in my judgment, the fact that the world's policymakers have largely abandoned 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 strengthening the U.S. 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 individuals and nations to devote their scarce resources to the most advantageous uses and then exchange their products with others to satisfy diverse preferences. This process allows specialization and gives rise to markets. The lifeblood of trade is communication, which 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 better our ability to specialize, the broader our markets, and the more prosperous we become. These are not new ideas. They have shaped our understanding of how nations become wealthy since Adam Smith described them more than two hundred years ago.

Today, we are experiencing a great technological revolution—a communications revolution. The proliferation of microprocessors and other innovations in 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 market expansion has allowed the U.S. 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 break down the complex, unproductive network of artificial trade barriers that characterized much of the previous century.

The role of international trade and finance in renewing Ohio's prosperity in the past decade is noteworthy. From 1987 to 1997, Ohio's exports grew 60 percent faster than exports overall in the United States—and U.S. export growth was very strong indeed. By 1997, Ohio had jumped from being the eleventh-highest export state to being the seventh. And in 1996, the Cleveland area ranked twenty-third in the nation's top 70 export communities.

This region's influence in the world economy continues to grow as its capital base expands. Data from the U.S. 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 U.S. capital additions. Specifically, while U.S. industry was adding about 4¼ percent annually to its stock of industrial capital, Ohio was adding capital to its industry at a 5 percent clip.

In 1998 and 1999, slightly more than 2,100 major new projects were begun in Ohio, which ranks among the top five states in attracting and expanding business. Moreover, about 6 percent of these business expansions were financed by foreign investors. The Ohio Department of Development estimates that 851 foreign-owned corporations provided only slightly less than one in 20 jobs in the state last year. Almost 75 percent of the foreign establishments were in the manufacturing sector, where trade opportunities have been greatest. And the single largest regional concentration of foreign-owned businesses was in Cuyahoga County, with 145 establishments.

What has this investment wrought? Today, output per hour in the region's manufacturing sector hardly resembles the economy of 15 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's industrial machinery workers jumped—from more than 10 percent below the national average to more than 10 percent above the national average. This story could be repeated for a number of industries throughout the region.

The Cost of Growth

Economic transformation has its cost. Between 1977 and 1987, U.S. industry reduced production jobs in manufacturing by 1.4 million workers. More than 200,000—or 15 percent—of those jobs were in Ohio. More than half of Ohio's job losses were concentrated in two industries—primary metals manufacturing and industrial machinery manufacturing—each of which lost upwards of 50,000 jobs over the decade.

In fact, the region could not have achieved this new competitiveness without the dramatic changes of the 1980s. Is there any economic progress 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 under constant competitive pressure to reinvent themselves. As they move toward higher levels of productivity, they necessarily make some 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 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 see that some economic policies of the past century inadvertently, or in some cases intentionally, did just that. They directed or misdirected economic growth either by substituting policymakers' judgment regarding the distribution of an economy's assets for the combined wisdom of individuals or by 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 artificially altering the measures of value, that is, prices. One such policy, known as "beggar thy neighbor," involved manipulating the exchange rate in order to boost a country's exports. Trade restrictions also were 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 World War II. 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. The most egregious form of this policy was in planned economies. But many democratic economies, as they recovered from wars and other traumas, nationalized entire industries. Our society never found that degree of government intervention appropriate, but we did regulate some business decisions for certain industries, such as electric power distributors and airlines, attempting to overcome the "natural monopoly" or "excessive competition" characteristics perceived to exist in these industries.

Finally, in an effort to regulate their business cycles, some central banks engaged in policies that artificially altered the path of domestic prices. 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 accelerate growth. They were based on the misunderstanding that accepting higher inflation could produce lower unemployment in the long run. But it gradually was recognized 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 by inflating prices ended up impeding markets and reducing economic prosperity. We now know that there is no long-run trade-off between inflation and unemployment. The U.S. experience of the last several years has also taught us that low, stable inflation is the underpinning for sustainable growth and that such 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 trade-off 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 long-distance transactions, businesses have sought more globally integrated production processes, and investors have required the development of financial instruments to satisfy their demand for international portfolio diversification. Such developments have put enormous pressure on policymakers to loosen their grip or abandon policies that misallocated 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, policies have been liberalized because of the realization that markets allocate resources more effectively than governments can.

Trade is flourishing, gaining great momentum in the 10 years since the Berlin Wall fell. Total trade with foreigners now accounts for about one-quarter of total U.S. national output—more than twice the share of the period between 1920 and 1970 and the largest trade share for the U.S. 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 the government's past efforts to deregulate industries. The removal of unnecessary government regulation started more than 20 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 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 its operating activities more transparent.

Regarding monetary policy, central banks around the world are now endeavoring to stabilize their domestic price levels. In some cases, this focus on price stability was designed to restore the central bank's credibility after a period of unacceptable inflationary pressures.

The Federal Reserve too should facilitate transmission of the information that the price level is meant to convey. When a stable purchasing power for money is maintained, workers and firms see more clearly the values being attached to their opportunities and allocate their resources more effectively. Ours is a monetary policy that does not attempt to alter the information transmitted by the marketplace but rather to increase its clarity and consistency.

The increased openness of Federal Reserve decisions — reflected in more rapid and transparent dissemination of Federal Open Market Committee decisions — also should be appreciated as a way of facilitating the communication to and within the marketplace to promote the most effective policy possible.

Conclusion

As an economic policymaker, I believe that "building a world-class economy" isn't about trying to manufacture various economic outcomes. Fortunately, most policymakers now recognize that their role in the process is to help develop the infrastructure through which people communicate. We need to provide the public with tools that allow it to judge value accurately and to see opportunities with the greatest clarity. Economic policy, including monetary policy, must be an integral part of the communications revolution that is sweeping the world.

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The views stated here are those of the author and not necessarily those of the Federal Reserve Bank of Cleveland or of the Board of Governors of the Federal Reserve System.

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