

Speeches

Responding to Global Competitive Pressure

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Thank you for the nice introduction. And good afternoon. Not long ago, Linn Yeager was kind enough to come by my office and talk to me about TAPPI and your symposium here in Atlanta. He tells me there are people in the audience not only from the United States but also from Austria, India and Chile, among many other countries. What I admire in particular is how you all compete in the global economy. Like the athletes in the Olympics, you contend with the best. And you must be in top condition every day.

As president of the Atlanta Fed and a participant in Federal Open Market Committee policy debates and decisions, I spend a lot of time meeting with economists and going over data about economic growth, prices and labor markets. It's important work, and, frankly, the job is fascinating and quite satisfying. But sometimes the process of economic analysis and monetary policy can get theoretical and pretty far removed from the hard facts of business life.

So, when I'm away from the office, I sometimes like to work with my hands. I grew up in the mountains of Virginia, where my father was a high school teacher who taught the farm boys woodworking, among other subjects. And I spent a lot of time in his shop. While I won't profess expertise in working with your laminate products, I still do a little woodworking when I get the chance. In fact, I plan to come back downtown this weekend to visit the woodworking show next door.

In a sense, I think of the big woodworking show as kind of a microcosm of our economy. You find terrific energy in one place, and the pace of innovation is relentless as people from around the world constantly devise new and better ways of doing things. The types of tools and materials on display now would have seemed unimaginable in my father's day.

When I think about the non-stop transition in our economy, I am reminded of a phrase coined by the late Joseph Schumpeter, an Austrian economist who taught at Harvard. The phrase I'm referring to is "creative destruction."

In regard to manufacturing, we've heard a lot lately about destruction of jobs and industries, but not much about the creative part. We've been told that jobs are moving overseas. We've been told that Americans can't compete in a world of low cost labor and that we risk becoming a nation of service providers.

Well, some of these points are valid. China and other countries have emerged as manufacturing powerhouses. And in the United States roughly 3 million manufacturing jobs were lost between July 2000 and the low point of January 2004, and a lot of workers and their families in this country have languished as a result.

But there is more to the story. Despite the upheaval, I want to stress the point today that manufacturing remains vital to our nation's economic health and balance. To borrow a phrase from Mark Twain, the news of manufacturing's death has been greatly exaggerated. But we should not expect the future of manufacturing to resemble what we have seen in the past.

I plan to say more about manufacturing in a moment. But to build a foundation for that discussion, I'd like to first take some time to discuss the U.S. and global economic outlook.

Economic outlook

For a while now, I've been talking about how our economy has steadily gained strength. During and after the recession of 2001, consumer spending provided a rock-solid foundation for the U.S. economy. And as growth resumed, business spending began to pick up, industry by industry. Then, last summer and fall output growth roared ahead. The only missing piece of the expansion was employment. And earlier this year, it looked like job growth, finally, was starting to gain a foothold.

This hopeful outlook, however, might seem at odds with some recent economic data. Output growth at 3 percent for the second quarter was below expectations, and job growth in July slowed to a trickle.

Let me be clear: I don't like to read too much into a month or two of data. But in light of recent reports, I would concede that it's fair to question what's ahead. You might ask if the economy is getting bogged down for an extended stretch of eroding growth. Or are we just going through another brief soft patch on our way to sustainable recovery?

Before I give you my answer to that question, let me acknowledge up front that persistently high energy prices have placed an unusual burden on consumers. And I suspect consumer spending has been slowed by heightened concern about terrorism related to the U.S. presidential election, the Olympics and other events. Certainly, these developments help to explain some of the recent loss of momentum.

With regard to employment, I take some comfort in looking back at monthly data over time. Even during the boom period of the 1990s, we saw fairly wide fluctuations in job growth from month to month. New job creation this spring was impressive, but over the summer it faltered. There are still more than a million fewer jobs than there were at the beginning of 2001. Clearly, we need more jobs to sustain growth.

The employment riddle can be explained in part by a return of caution among some business leaders. Certainly, if you look at corporate balance sheets and profits, the United States business sector is in remarkably good shape. But it appears that many leaders of large businesses remain uneasy about adding to payrolls. And this reluctance is understandable given the geopolitical developments and high energy price risks I just outlined, along with continued productivity gains. At this point, it

appears businesses are still inclined to squeeze the last ounce out of existing staff while leveraging new technology to operate as efficiently as possible. Even with these constraints I think we should continue to get sufficient job growth to gradually push the unemployment rate lower, although we should not be surprised at large month-to-month fluctuations in the employment data.

If you look at the economy sector by sector, the likelihood of solid and sustainable growth looks good. Homebuilding is holding up well, and exports are growing nicely along with steadily rising world GDP. Here in the Southeast, tourists have returned and future bookings are reported to be strong. My contacts in commercial real estate, one of the last sectors to gain in the recovery, have become more optimistic, with more new projects in the planning stages.

Even manufacturing, which in some industries was ill-equipped for global competition only 18 months ago, has become more lean and fit and is now contributing to growth. The Institute of Supply Management's manufacturing index rose in July for the ninth straight month, and manufacturing production was up at a solid rate just over 7 percent during the second quarter. Manufacturing payrolls edged up 10,000 in July and so far this year have increased by 81,000.

Price pressures

I've been saying for a while that this recovery would be unusual, and, sure enough, the twists keep coming. A few months ago, we started to hear frequent reports of price increases and the return of pricing power in a number of industries. An upward trend in broad inflation measures also was evident. But more recently there are signs that these price pressures may be starting to ease. At the same time, I am not yet willing to conclude that all of the price pressures we've seen will turn out to be transitory. While many of the increases associated with high prices for oil and other commodities should reverse in time, I continue to be struck by the extent of cost pass-through. In fields where demand is strong and growing, we are seeing price increases beginning to stick.

Although troublesome inflation problems do not seem imminent, a continuation of accommodative monetary policy is not appropriate as the economic expansion gains momentum and breadth. And as you know, the FOMC this year raised the Fed funds target rate by a quarter of a percentage point at both our June and our August meetings. I would like to emphasize that these policy moves were not taken, as some have suggested, because policy makers believed the economy was growing too fast. Rather the data and anecdotal reports we have at this time continue to suggest we can work our way toward a more neutral interest rate setting in a "measured" way. The objective is to pave the way for sustainable growth. But it's important to keep in mind that we can all be surprised by output and price developments as they unfold, and as our June and August statements noted, the FOMC has the flexibility and "will respond to changes in economic prospects as needed..."

As I mentioned a moment ago, the rise in energy prices has been an unwelcome development. The cost of a barrel of oil has climbed by about a third this year to about \$45. Stronger economic growth around the world — especially in Asia — has boosted demand for oil. At the same time, constraints in refinery capacity coupled with geopolitical problems have disrupted supplies to an unusual extent. I have no better basis than oil futures markets for speculating as to how long this climate will continue. However, the longer oil prices remain at or near these all-time high levels, the greater the shock to the economy.

As you know, rising oil prices ripple through our economy, forcing airlines, trucking companies and other businesses to adjust by looking for more ways to cut costs, by absorbing the added costs in their profits or by passing along those costs to their customers. As I noted earlier, consumers also take a hit. Because they are paying more for gasoline and for other essentials such as heating oil, they have less money to spend elsewhere.

There was clear evidence of slower consumer spending in June, but retail sales and housing starts bounced back in July. Looking ahead, my sense is that the recent softness in the economy, while somewhat disappointing, is more fleeting than fixed. I expect momentum to resume, and I think we'll see good output and job growth over coming quarters. Consumers probably won't open their wallets as wide as they did in 2003, but I anticipate a return to respectable consumer spending, consistent with an acceptable pace of growth in GDP.

A key reason I believe the economy will stay on course is the increasing breadth of the expansion we've seen since last summer. Business spending growth is now comparable to the 1990s following a sharp decline in 2001. Industry by industry, businesses have resumed the trend of investing heavily in productivity enhancing technologies such as new computers and industrial equipment. And capacity is being expanded in industries where demand has come back strongly.

All of the money businesses are pouring into new equipment is helping to reinvigorate the manufacturing sector in particular. But as we look ahead, it's important to understand how manufacturing is changing, and that's what I'd like to discuss for the next few moments.

Manufacturing over the long run

American factories are more efficient than ever in terms of how labor is used. But this is not a new trend as manufacturers have employed fewer and fewer workers going back half a century. In 1955, more than 30 percent of American non-farm workers were employed in manufacturing. That figure was around 11 percent in 2003. Despite this, the U.S. share of the value of manufacturing output remains essentially unchanged. I expect you have seen and felt this sea change of improved productivity that has enabled businesses to cut payrolls and still boost output.

In certain ways, the plight of manufacturing employment is similar to what has already occurred in agriculture. Over many decades, farm production became largely automated. Since 1955, agricultural employment has declined steadily from more than 10 percent to less than 2 percent of total civilian employment in the United States.

Yet, as with manufacturing, agricultural output has continued to increase, along with the U.S. share of the value of agricultural output. And today, America remains a leading exporter of farm products.

So I think you can see how technical innovation applies over time to increase labor productivity. As these gains take hold, our standard of living improves through higher profits, increased wages and better and often cheaper goods.

The human consequences

It's hard for me to be dispassionate about job losses, especially since manufacturing is part of the American identity and has supported so many workers and their families. As a policy maker, I believe it's important to try to better grasp the human consequences of "creative destruction."

In this regard, our Atlanta Fed economists have been analyzing restricted data from the Georgia Department of Labor. They examined how business cycles influence hiring and compensation for workers who have switched jobs. Our research found that workers who left manufacturing jobs during the 2001 recession wound up in

worse shape, in terms of wages in their next job, than the folks who switched jobs during the long expansion of the 1990s. Notably, the ones who fared the worst were laid off by facilities that were shutting down completely. In part, this is because a plant shutting down floods the local labor market with new job seekers. These workers suffered a wage loss nearly twice as large as workers who left firms that were merely downsizing.

I'm sharing this research with you because it casts light on some of the wounds inflicted by a weak economy. As economic growth improves, workers of all stripes face much brighter prospects. But, at the risk of oversimplifying, our job market still has trouble matching supply and demand for skills. There are job shortages in growing fields, such as health care and education. And there is demand for skilled tradesmen, such as electricians and plumbers. Typically, however, workers in these fields must have years of training.

One of the biggest problems in this country is the large number of people who want to work but don't qualify for decent job openings. When I think about what can be done to help workers to cope with global competitive pressure, I am reminded again of my father. As I said earlier, he taught woodworking and other useful trades, and he encouraged learning as a lifelong process. I believe we would strengthen our society and our economy by investing more in programs to teach adults skills for the modern workplace.

The future of manufacturing

Not long ago, I had a glimpse into the future of manufacturing in, of all places, Canton, Mississippi, just outside of Jackson. Canton is the site of a new Nissan plant, where they make Quest minivans and other vehicles. When I toured the facility, which cost \$1.4 billion, I was really impressed by the use of technology. Wherever possible, Nissan installed robotics to enhance productivity. But a skilled workforce still is needed to run and maintain the machines, and some auto assembly processes remain labor intensive. Nissan employs about 4,000 full-time workers in Canton. Many of these jobs offer very good compensation and require higher education and advanced skills. This highly efficient and cost-effective manufacturing facility, along with other new auto-related facilities that have opened in the Southeast over the past decade, have helped to take the place of less skilled and more labor-intensive manufacturing that has moved to other parts of the world.

To compete in today's economy, we have to play to our strengths. Here in the Southeast, many apparel plants have closed permanently because they have not been able to offset high-wage costs in a labor-intensive business. In various industries, companies are succeeding by filling specialty niches where the business model stresses quick delivery of unique products. You may see the same forces at work in your business, where some of the leading suppliers operate from high-wage markets in Europe.

As jobs and capital ebb and flow across borders, we hear more calls to manage trade and stop jobs from moving overseas. Maybe it's possible to stem some of the job losses, at least for a while. But, in my nonpartisan view, I believe that in the long run barriers to capital and trade almost always prove futile, like building fences to keep out the crows.

Given the turbulence in our interconnected economy, you may have to look hard to find progress. But I assure you it's there. Go to the woodworking show here in Atlanta, and you'll see hundreds of professionals looking for ways to do their work better. Who knows? Maybe a cabinetmaker will learn about some new piece of equipment that enables him to do more refined work and finish jobs more quickly. His investment may pay for itself in a few months, and it could lead to a better standard of living for his family and lower prices and better products for his customers.

In our global economy, the innovation is relentless, while the opportunity is endless. I know change is hard. But the economic outlook continues to improve. And I hope you'll agree that businesses and workers around the world are better off when they are free to compete with the best.

Thank you for allowing me to share these thoughts, and perhaps I'll see some of you at the woodworking show.

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