

## CONGRESSIONAL BRIEFING

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### **Assessing the Midwest Economy**

We're here to discuss a study of the Midwest economy completed by the Federal Reserve Bank of Chicago. The goal of the study is to better understand the region's future prospects by studying its past...specifically the Midwest's dramatic comeback since the early 1980s. We hope meetings like this one will trigger discussion on how to use the study as a tool for developing effective policy.

To start things off, I'd like to give a brief overview and then turn the podium over to my associate Bill Testa, who will discuss the study in more detail.

As I mentioned, our study has taken a close look at the region's remarkable turnaround. Why have we prospered in recent years? Is our success due to external factors that the region can't control, like a stronger dollar? Or is it due to internal factors, such as productivity improvements? In other words, were we lucky or were we good?

First, let me give some background on the study. Why did the Chicago Fed undertake this study? One reason is that we're a regional institution...uniquely positioned to study the Midwest and communicate information to policymakers. This study also helps the Chicago Fed do a better job in contributing to national monetary policy. We've enhanced our understanding of the Midwest economy—how it's likely to develop...how it could be affected by factors such as NAFTA or new welfare legislation.

Our study focused on the five states that make up the Fed's Seventh Federal Reserve District—Illinois, Indiana, Iowa, Michigan and Wisconsin. We used an open and cooperative process. We held a series of workshops featuring leading experts who contributed their time to present research on a wide range of issues. In this way, we were able to bring many voices, ideas, and information to the table...over 200 participants took part. To help provide guidance to the effort, we established an advisory group, which includes the governors of the five Seventh District states as honorary members. Each of the governors has a representative on the

group. The group also includes six university presidents as well as representatives from business, labor, and not-for-profit organizations.

We looked at many different aspects of the regional economy—global linkages; the labor force and education policy; the rural economy; tax and regulatory policies; the performance of metropolitan areas; and changes in the manufacturing sector. Some 30 studies have been produced, as well as summaries of each of the workshops, which include many additional ideas and facts.

## Study Findings

Now, I'd like to give you the flavor of our findings. It's easy to forget, but the Midwest economy is one of the surprise stories of the nation.

The Midwest economy lay in shambles fifteen years ago—at the bottom of the steepest recession since the Great Depression. One of five Midwest manufacturing jobs disappeared from mid-1979 through '82. Unemployment in the region was a full three percentage points above the nation.

Some people were writing our epitaph. But the rumors of our demise were greatly exaggerated. Today, the Midwest unemployment rate is a full percentage point below the nation. The region's old image as the nation's "Rust Belt" has disappeared. The Midwest today is more of a well-oiled machine.

So was the Midwest lucky or good? The Midwest was both lucky and good, as it turns out. But the most important lesson for the future is that we were good. That indicates that we can influence our own destiny by continuing to improve our competitiveness.

A critical factor in the Midwest's success was its willingness to re-invent itself. The Midwest received a wake-up call. The region found itself facing intense competition...competition from other countries and competition from other regions in the U.S. The Midwest responded and initiated a painful, broad-based restructuring.

The source of the recovery? Our old mainstays—basic manufacturing and agriculture. These economic sectors led us down into the valley...and they are leading us up the hill. We haven't changed what we're doing. But we're doing it much more efficiently...at a world class standard.

The Midwest is still heavily dependent on manufacturing and agriculture, despite all the changes to its economy. The region is more concentrated in these sectors than the rest of the nation. The Midwest's share of personal income derived from manufacturing jobs was 27 percent in 1994. That's 46 percent above the national average. The Midwest's share of personal income derived from agriculture and related industries was 3.6 percent—about 12 percent above the national average.

The auto industry provides a good example of the region's manufacturing orientation. The auto industry is reconcentrating in the Midwest. During the last 17 years a lot of auto plants have shut down—a total of nine in the Midwest. But 13 new plants have opened in the Midwest. 31 out of 58 auto assembly plants in the U.S. are now located in the Midwest. The auto industry is actually more concentrated in the Midwest now than it was back in 1979.

The Midwest turnaround isn't simply a story of renewed productivity in manufacturing and agriculture. Our Midwestern cities have diversified, transforming themselves from manufacturing centers to providers of specialized services, such as business and financial services. We've seen the same trend occur in smaller metropolitan areas, but it's much more concentrated in large cities in the region.

Our cities have successfully diversified, but they face serious problems. Economic activity has spread out toward the urban fringe, leaving problems for the core cities. Today much of the region's unskilled work force is concentrated in the central cities. The result is not surprising. In Chicago, for example, the poverty rate is almost 22 percent, compared with 12 percent for the overall metro area.

As I said, manufacturing is leaving the cities. Where is it going? To rural areas, in some cases. Manufacturing growth in rural areas has greatly exceeded that found in metropolitan areas in recent years. However, rural areas seem to be attracting relatively low-paying manufacturing jobs. Are the skills of rural workers a problem? Some have suggested that the quality of rural education is poor. We didn't find that to be true. Our study indicates that the quality of rural education is better than it was in the past and about equal to that found in urban areas.

The major challenge facing rural areas is related to productivity improvements in manufacturing and agriculture. That's an absolute necessity in an increasingly global marketplace. But such productivity can translate into fewer jobs. In the ag sector, the Midwest is seeing a decline in the number of farms and the emergence of the mega farm. That's a key issue as the region is losing its dominant position in hog and dairy production as mega farms go to other states. Implications for the Future

The Midwest faces many challenges but the region is doing much better. How do we maintain our momentum? Our study suggests a number of approaches. I'd like to briefly focus on a couple of broad issues:

One—an increased emphasis on education and work force training; and

Two—the importance of competing in the global economy.

In many ways, the most crucial element is education and training. As you know, industries increasingly require strong minds rather than strong backs. The increased importance of brain power can be seen in the marketplace. For example, a recent college graduate in 1978 could expect to earn 38 percent more than a high school graduate. By 1994, that difference had increased to 73 percent. Unemployment rates tell a similar story. The unemployment rate for high school drop-outs was approximately 15 percent in 1994, as compared with 4 percent for college graduates.

So high-quality education is essential. The Midwest has been somewhat of an incubator for reform efforts from school finance reform in Michigan to a voucher program in Milwaukee. There are many initiatives underway in the region, but they remain small in proportion to the number of students.

Workforce training is another key area. We need programs that reflect the new realities of the labor market. Work place training has to match more closely the needs of employers. Workers need to receive certifiable skills that can be transferred from one employer to another. As we all know, the old model of lifetime employment in one company is a thing of the past.

Another tough question is how to train disadvantaged workers. So far, training such workers has been a lengthy and costly process. One of the participants in our Midwest study described a relatively successful program here in Chicago.

Work force programs usually emphasize a strong dose of training before the worker starts a job. This alternative program stresses putting welfare recipients from the Cabrini Green housing project into a job quickly, with minimal prior training. After starting to learn the discipline of a job, the worker may be offered support services such as child care, counseling, and more extensive training. If they lose the job, they get help in finding another. It seems that the best training is to get on the job as quickly as possible, especially for people who are still learning the value of education and training.

The second broad issue I'd like to cover is the global economy. In the last few years, exports from the Midwest have grown even faster than for the nation. That reflects the fact that we tend to make products that other countries want—things like farm machinery, electrical generators, and machine tools. That's especially true for developing countries, which need these products to establish new industries and make their existing industries more competitive.

That's very good news for the Midwest. Because developing countries—particularly in Asia and Latin America—are where the growth is. A quarter of a century ago, 29 percent of U.S. exports went to developing countries. These same countries absorbed 41 percent of U.S. exports last year. This is a trend that the Midwest is well positioned to take advantage of.

Our study highlights the competitiveness of the Midwest economy in the global marketplace. According to common wisdom, the Midwest benefitted quite a bit from the declining dollar, which made its exports cheaper for overseas buyers. This is a logical conclusion, given the results of studies that have looked at the value of the dollar and the nation's major trading partners.

Research by Chicago Fed economists took a different approach—a regional approach. Our economists looked at the value of the dollar and its effect on the Midwest's major trading partners. They found that the dollar did not decline in those countries. In other words, the Midwest did not have a built-in price advantage from the weaker dollar. It appears that the Midwest succeeded because of better products and prices, not just because of external factors such as the performance of the dollar.

I've worked as a trade representative, so you won't be surprised that I think it's essential to continue to reduce trade barriers. It's especially important for the Midwest. Our study indicates that the region has benefitted from the expansion in global trade and is well positioned to continue as a very effective competitor in the global marketplace.

## Conclusion

In closing, let me say that there is reason to be optimistic about the Midwest economy. The Midwest has been hit especially hard by recessions in the past. The recessions of the early 1980s are probably the best examples. The Midwest's problems weren't too surprising since we specialize in manufacturing, which tends to be sensitive to downturns in the economy.

Perhaps we've broken that pattern. As I said, we haven't changed what we do. But we have changed how we do it. We're more productive...a very effective competitor in the global marketplace. Today, we're better positioned to withstand downturns in the economy than we were in the past.

So, a look back indicates that we can influence our fate...we can affect our destiny. We have a window of opportunity that we can use to maintain our economic momentum.

Our study covers a broad range of issues. Some are in the hands of state and local government. But there's an important role for Federal policymakers. That's true, of course, in reducing trade barriers. But I'd also like to mention that the Federal government can help state and local policymakers by fostering the development of information and research.

Gathering information on a state-by-state basis is usually an inefficient process. It became very clear during the course of our study that there's a need for more information and understanding about what works and what doesn't. A one-size-fits-all approach to policy is not appropriate as the economy becomes more complicated. But we'll need better information and communication to develop effective and innovative regional policy.

Our study is a starting point for identifying the critical issues facing the Midwest. It's more a point of departure than the final word on the subject. But I believe it will be an essential first step in allowing us to build on our past success.