

ASSESSING THE MIDWEST ECONOMY:
CHALLENGES AND PROSPECTS FOR INDIANA

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Midwest Assessment: An Introduction

My role today is to give a brief overview of the Chicago Fed's study of the Midwest economy. I'll then turn the podium over to my associate Bill Testa, who will discuss the study in more detail.

The goal of the study is to better understand the region's future by studying its past -specifically the Midwest's dramatic comeback since the early 1980s. We hope meetings like this will trigger discussions on how to use the study as a tool for developing effective regional policy.

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 declining 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 provide some background on the study. Why did the Chicago Fed undertake this effort? 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 by enhancing our understanding of the Midwest economy.

Our study focused on the five states that make up the Fed's Seventh Federal Reserve District — Illinois, Iowa, Michigan, Wisconsin, and, of course, Indiana. We used an open and cooperative process, holding 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 Governor O'Bannon as well as the governors of the four other Seventh District states as honorary members. The group also

includes representatives from business, academia, labor, and not-for-profit organizations. Among the representatives from Indiana are Charles Bonser, from the Institute for Development Strategies at Indiana University; Christopher LaMothe, president of the Indiana State Chamber of Commerce; Graham Toft, president of the Indiana Economic Development Council; and Myles Brand, President of Indiana University, all of whom are here with us today.

Study Findings

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

As you know, the Midwest was known as the Rust Belt back in the early '80s. At that time, our economy lay in shambles — 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 almost three percentage points above the nation. People had written our epitaph.

Today, the Midwest unemployment rate is a full percentage point below the nation. Indiana's unemployment rate is two percentage points lower. And the Indianapolis metro area is 3 percentage points lower than the state — despite the trend for many of the larger metropolitan areas to do worse than the rest of the nation.

During our study, we looked at a number of factors, such as:

- Activities by private sector firms
- Government policies
- And external forces, such as changes in the value of the dollar

What did we find? Was the Midwest lucky or good? Well, it was both lucky and good, as it turns out. But the most important factor was that we were good. The main reason for 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 to the challenge and initiated a painful, broad-based restructuring.

Midwest producers reduced costs, created new product lines, and made remarkable productivity enhancements. A fact we found interesting was that the Midwest renewal was already underway even during the dark years of the 1980s.

And the source of the recovery? Our old mainstays—basic manufacturing and agriculture. These economic sectors led us down into the valley — and they're 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.

Today, the Midwest is still heavily dependent on manufacturing and agriculture, despite all the changes to its economy. For example, the Midwest's share of personal income derived from manufacturing jobs was 27 percent in 1995. In Indiana, the state's share of personal income derived from manufacturing is 33 percent [32.7%]. As a point of comparison, the share for the U.S. is only about 18 percent [18.5%].

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

What about Indiana? Indiana has moved towards being the manufacturing Main Street of the Midwest. The state has been at the center of the Midwest revival in the auto industry. Growth in the state has been tied to both foreign and Big Three automakers. We've seen growth in auto assembly plants as well as parts plants. Job growth in the automotive industry from 1991 to 1996 has accounted for 30,000 additional jobs. That's over one-half of Indiana's job growth in manufacturing over the period.

But manufacturing is not the entire story. The Indianapolis metropolitan area has transformed its economy from a manufacturing center to a service economy. It's done this by providing transportation and warehousing services as well as business services—especially financial services, and travel services for recreation and business meetings.

We all know the importance of agriculture and its revival to smaller metropolitan areas, towns, and rural areas. But manufacturing has had a role to play as well. Manufacturing is leaving the cities. Where is it going? To rural areas, in many cases. Manufacturing in rural areas has grown in recent years, unlike in large urban areas.

The major challenge facing rural areas is related to ongoing productivity improvements in agriculture. That's an absolute necessity in an increasingly global marketplace. But such productivity can translate into fewer farms and farmers, and declining population for many farm towns. The Midwest and the state of Indiana are seeing a decline in the number of farms and the emergence of larger and larger farms. That's a key issue as the region looks to the future.

A key advantage for the Midwest is its increased competitiveness. This is highlighted by research by Chicago Fed economists. 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 looked at the value of the dollar relative to currencies of the nation's major trading partners.

Our economists took a different approach — a regional approach — and looked at the value of the dollar relative to currencies of the Midwest's major trading partners. Following the 1985-86 period when the dollar fell sharply, our economists found that the dollar then actually appreciated from 1987 to 1996. 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.

Our success in the global marketplace is a good sign for the region's future. Exports now account for a much larger share of the U.S. economy — about 13 percent as compared to only 8 percent in 1987. 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 transportation equipment, food processing machinery, electronic equipment, pharmaceuticals, corn and soybeans, and steel and steel products.

Developing countries 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, less than 30 percent [29 percent] of U.S. exports went to developing countries. Last year these same countries absorbed more than 40 percent [41 percent] of U.S. exports. This is a trend that the Midwest is well positioned to take advantage of — because of its products, and because of its renewed competitiveness.

Implications for the Future

So the Midwest is doing better. How do we maintain our momentum — and continue to compete on a world class standard. Our study suggests a number of approaches. I'd like to briefly focus on two broad issues:

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

Second — a heightened focus on region-specific policies.

In many ways, the most crucial element is education and training. As you know, industries increasingly require strong minds rather than strong backs. Entry level jobs often require computational and even computer skills that weren't necessary 20 years ago. This puts a premium on developing education and training models that prepare individuals to be life-long learners.

High-quality education, of course, 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.

Clearly there are many initiatives underway in the region. But they remain small in proportion to the number of students.

Workforce training is another key issue. 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. The old model of lifetime employment in one company is a thing of the past.

This move toward industry-wide, certifiable skills has already begun here in the Midwest with Indiana playing a significant role. The Council of Great Lakes Governors, of which Indiana is a member, has formed a partnership with the National Tooling and Machining Association to develop skills and credentials programs for workers in the metalworking industry. Workers with these credentials will be able to move from one company to another more freely. And companies will know what skills the workers have.

Education and workforce training are subjects that we'll be covering in-depth later today. I'm looking forward to our discussions.

The second broad issue I'd like to mention is increasing our understanding of regional strategies. Our study found that economic flows within the Midwest are highly connected. Take the trading of goods and services. Where do Midwest states send most of their goods? Not overseas. Most of the Midwest's trading activity takes place with other states in the region.

Reducing the barriers to trade between the states in the Midwest could pay significant dividends to the region's economy. These barriers include unnecessary differences in areas such as occupational licensing and environmental regulations

Another potential area of improvement is our tax structures. Let me say first that our state governments have contributed to the region's success. The Midwest states have done a good job in developing prudent fiscal policies. They've avoided debt and they haven't dramatically increased taxes to balance their budgets.

In fact, the Midwest has done a better job of positioning itself as a desirable place to do business, with tax rates that are close to the national average. But there's room for improvement. Our study found that taxes paid by businesses far exceeded the benefits of the services that these businesses received. Aligning our business tax structure to address this issue would probably help economic development.

Conclusion

In closing, let me say that there's reason to be optimistic about the Midwest economy. The Midwest has been hit especially hard by recessions in the past. 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.

For example, the recession of 1990-91 was the first time in decades that the Midwest did better than the rest of the nation during a recession. But we still face a significant challenge. Our concentration in manufacturing will always make it tough to weather a downturn in the economy. But we're in much better shape than we were 15 years ago.

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 is a starting point for identifying the critical issues facing the Midwest and Indiana. 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.