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**Changes in the Business Environment and How They Affect
Prospects for Growth:
A Long-Run View**

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Introduction

Thank you.

It is a pleasure to have this opportunity to address the Executive Network. Programs such as this strengthen our community by facilitating communication among people who have both a stake in the well-being of the Greater Cleveland area and, collectively and in some cases individually, the ability to influence what happens here.

This evening, I want to share with you some thoughts about why we have reason to be optimistic about the outlook for our world, our nation, and our community. That optimism stems from trends and forces in the political sphere, the economic sphere, and the technological sphere. Most of these trends are global in scope, and most have a strong element of inevitability.

Plain Dealer - Bicentennial

- Letters 1896-1996
- Machines that fly?
- Letters for 2096?
- Do-it-yourself, home bone-marrow transplants?

Caveat:

Hazards of long-term projections

1890 ⇒ 1920

- one of largest occupations in major metro areas such as New York City:
- men with shovels and carts to clean up after horses

Early years of 20th Century,

- automobile: hailed as an anti-pollution/cleaner environment,
- technological advance -- vs. alternative.

1900: U. S. Ice Trust // icemen

The Long-Run Trends

The prospects for the next 10 to 15 years are extremely favorable and very exciting. Trends in technology and in political and economic institutions and policies will combine to produce what may turn out to be the best period since the 1920s and perhaps the best decade or two ever.

Political Trends

Let's first look at some important political trends. Three months ago: 6th anniversary of when (November 9, 1989), the Berlin Wall came down, symbolizing the failure of communist central planning and the demise of the Soviet Empire.

Imagine just a few years from now, in the early years of the next century (and next millennium), teachers in high schools explaining to students that, in the middle of the 20th century, in the words of Winston Churchill, it seemed that an iron curtain had fallen through the middle of Europe.

Other side of curtain:

- no private property: apartments, shops, farms;
- could not buy products made in Western countries;

- no job changing jobs; could not “go into business”;
- could not simply decide to move from one city to another; and you were not even allowed to travel outside the Soviet Union
- or receive radio or TV news programs, newspapers, magazines, movies or any other information from the West.
- will sound obviously “dumb and unworkable”.

As long ago as 1945, Friedrich von Hayek, the renowned Nobel prize winner in economics, pointed out that any regime of central planning contained a fatal flaw.¹ The flaw was that central planners must inevitably operate in ignorance of most of the information that a market system would generate to help people make wise decisions about production, distribution, and consumption. Operating without that information leads to extreme inefficiency.

Economic progress was hindered by the Soviet attempt to control its citizens’ communication with each other and with the rest of the world. Communication among scientists and others is a key ingredient of technological progress.

In his book, Turmoil and Triumph, former Secretary of State George Shultz tried to persuade Mikhail Gorbachev of this fact. Shultz told Gorbachev:

“This is a scientific revolution. There was a time when a government could control its scientific establishment and be basically successful. No longer. To keep up today and in the

¹ F. A. Hayek, “The Use of Knowledge in Society,” *The American Economic Review*, September 1945, pp. 519-530.

*future means that scientists will have to be in constant touch with the 'thinking community' around the world. And this is an information revolution. The inability of one nation to be predominant in the international financial world is going to be repeated in field after field. The key is going to be knowledge-based productivity, even in defense: an aircraft carrier is really one big information system."*²

The crumbling of the Berlin Wall will be treated in history as a major political event; but, that does not explain the underlying forces at work that produced the political event.

Shultz explained to Gorbachev that the accelerating pace of technological changes in information and communications was difficult for even the U. S. to keep up with, compared with places like Taiwan, Korea, Singapore and Hong Kong. Old Western Europe was falling behind the "Asian tigers", and for the socialist/communist, top-down, command-and-control economies, it was hopeless.

Gorbachev might have already recognized the power of such forces, and not long after taking power he launched his Glasnost and Perestroika reforms in an ultimately futile attempt to put some flexibility into the Soviet economy.

It is not so far fetched to say that our grandchildren will not worry about, and march in the streets to protest, nuclear missiles because of the technologies that brought us things such as FAX machines.

²George P. Shultz, *Turmoil and Triumph: My Years as Secretary of State* (New York: Charles Scribner's Sons, 1993), page 893.

Certainly the young people that participated in the tragedy at Tiananmen Square understand the power of FAX machines and other information and communications technologies.

- then, after 40 years, of Soviet isolation, it seemed as though the political leaders one day said, “never mind”, and the Iron Curtain suddenly collapsed; -- symbolized by the physical destruction of the Berlin Wall.

The fall of the Soviet Empire means that nations throughout the world are either already democracies or they are moving toward democracy.

We are now half way through the final decade of a millennium, and it is difficult, at best, to absorb the fact that the spread of democratic political institutions and capitalist economic systems to more people around the globe is occurring at a faster pace in this last decade than during the first 990 years of the millennium.

- before Berlin Wall came down (just over 6 years ago) -- 20% in markets and democracy
- now, something over 50% of 5 billion people and rising rapidly.

One of the consequences: the end of the Cold War has generated a major decline in the proportion of resources that the U.S. and other major nations are devoting to defense spending. [1945, 1979, 1986, now]. Thus, in the years ahead we will see a much smaller proportion of the world's resources going toward war and defense, and a much smaller amount of life and property being destroyed by war than was true on average in the 20th century. Those resources will instead be available to improve and increase living standards. The waste from war destruction is

easy to recognize, but the waste from preparation for war and defense is harder to see because so many people confuse production and employment with well-being. The jobs lost in defense industries are not a net loss to our economy. After a sometimes difficult transition, we will be richer because we spend less on defense.

Economic Trends.

Let me turn now to some favorable *economic* trends.

Greater use of markets. In addition to symbolizing the demise of the Soviet Empire, the fall of the Berlin Wall also symbolizes the end and the failure of the 20th century's great experiment with communist central planning, and more broadly, with government intrusion into economic life.

During the past six or seven decades, we have witnessed a great "contest of ideas" regarding the efficacy of market-directed versus centrally-directed economies. The 1930s represented a watershed decade around the world. In the wake of a world-wide depression, the response in many countries was to greatly increase government intrusion into such decisions as what could be produced and where, how much things would cost, how much could be paid for labor, what interest rates could be paid or received, and even how much profit could be earned, interest rates paid/received.

- Gold
- Regulation Q (adolescent)

The 1980s seem to have been another watershed decade, a time when previous beliefs about the appropriate role of government in the economy were questioned. People around the world came to recognize that living standards improved most rapidly in countries where markets, not governments, directed resource allocation. This is evident in comparisons not only between the centrally-planned countries and the western industrialized nations, but also among Third World countries with differing levels of freedom from government intrusion into everyday economic decisions.

Almost everywhere, government involvement in the economy is increasingly seen as a problem, not a solution. On every continent, we find examples of denationalization (privatization) and deregulation. It is hard to name a single country in which government is aggressively nationalizing private industry--instead, governments are either privatizing, deregulating, or maintaining the status quo. Controls on credit, interest rates, wages, prices, exchange rates, and capital flows are being removed. Such trends are likely to give a great boost to productive capacity during the next 15 years. In the jargon of economists, the world's production possibility boundary is being shifted outward.

Freer trade and capital flows. In addition to the movement toward greater freedom for markets domestically, there is a world-wide movement toward greater market freedom *between* nations.

These moves toward freer trade will make it easier for consumers to buy from the most efficient producers. In addition, the increased competition among producers will drive them toward greater efficiency and better service.

In some cases, free trade agreements include provisions for freer cross-border investment. This too will increase competition at the same time that it improves the allocation of the world's investment funds.

Another benefit of trade liberalization is that it increases pressure for domestic liberalization, that is, it increases pressures on government to remove restrictions that hamper the effectiveness of domestic firms. And, as domestic firms become more competitive, they in turn lobby for greater access to foreign markets. Thus, trade liberalization and domestic liberalization tend to be mutually reinforcing.

Several other important changes in economic institutions and policies will also be giving a major boost to economic prosperity during the next 10 to 15 years.

Counter-cyclical policies discredited. Over the last decade or so, the idea that fiscal and monetary policy can be used to prevent or end recessions has been largely discredited in many nations. As a result, we are likely to see fewer unwise attempts to “fine-tune” the economy.

- Stop/Go;
- Phillips curve/teeter-totter.

This new understanding about the limitations of government policies should contribute to greater prosperity by avoiding the harmful “pro-cyclical” outcomes that often result from those well-intentioned, but misguided, policies.

Price stability. Another beneficial trend is the substantial degree to which inflation has been eliminated.

- after 1973, on-the-job training;
- most major nations, the inflation rate has been brought down to between zero and 3 percent.

Low inflation and, more importantly, the expectation that the purchasing power of money will remain essentially constant over time, is akin to a technological advance. It will release resources from inflation hedging and risk avoidance activities and allow those resources to be used to produce goods and services that raise standards of living. In other words, policies that lead to price stability are policies that promote growth.

Another trend is toward:

Balanced budgets and smaller governments.

Today, we are all well aware of the popular consensus that the United States should move toward a balanced budget debate only when

Deficits:

U.S.: 1983 = -6.3

1996 = -2.7

Bringing federal spending in line with revenues, with or without a tax cut, also suggests that government spending will become a smaller percentage of GDP.

This view has its counterpart in western Europe, where shrinking budget deficits is one of the agreed preconditions for achieving the European Community's goal of a European central bank and a common currency. [Jackson: Sweden, Canada].

Reducing government deficits will increase national saving, making more funds available for investment and thus increasing production capacity. In addition, shrinking the relative size of government will mean that more resources are available for use by the private sector where they can be used more efficiently to raise standards of living.

Simpler tax codes. We also see serious proposals around the world for tax reform/tax reduction. The dominant trend is to tax consumption rather than income. Changing to consumption-based taxes would remove the disincentive to earn while increasing the incentive to save. This would increase the funds available for investment in things that enhance productive capacity.

- Early in the century (1913), tax rates on income: 1% - 7%.
 - in real terms today, 1% up to \$250,000
 - in real terms today, 7% only over \$750,000

The objective of any new tax structure should be to reduce the resources that individuals and businesses use to devise ways of avoiding taxes. Tax reform would free those productive resources, such as accountants, tax planners, tax attorneys, etc., from activities that seek only to influence the *redistribution* of wealth, and instead allow them to be used to actually *create* wealth.

Welfare reform. Welfare reform is another idea whose time seems to have come. There is a growing consensus that the welfare program of the past contained many perverse incentives. I don't pretend to know what the elements of reform will be, but it seems safe to assume that reform will change incentives in ways that encourage people to be more productive and to take more responsibility for their own and their families' well-being. Such changes cannot help but have a positive effect on living standards.

Technology -- Benefits and Challenges

- beginning of 20th Century -- wealth of nations
 - natural resources
 - raw materials
- national income accounting system --
 - numbers of things and tons of things
 - wheat, logs, coal and iron ore, etc.
- if natural resources actually were source of economic well-being,
 - Russia, Brazil, Africa
- instead, resources - poor places,
 - Switzerland, Japan, Taiwan, Hong Kong
 - size not important
- as century (and millennium) draws to a close,
 - knowledge-based, information-based

- human capital
- good news and bad news
 - institutions of higher education -- colleges and universities, “envy of the world”
 - primary and secondary (especially in central cities) often fail miserably, especially compared to schools in global competitors such as Japan, Germany.
- no doubt, early part of the 21st century, overhaul way we deliver primary and secondary education
 - unsustainable: habit of ending
 - failure not an option; keep experimenting until we find a successful formula
 - as certain as the collapse of the Soviet Union, the tumbling of Berlin Wall, and the reunification of Germany. [Reagan: “tear down that wall”]
- rapidly advancing information/communication/data processing/analysis technologies all increase the premium on human capital.
 - failure to dramatically improve the quality of education for the half of our young people who do not go on to college would mean a sustained worsening of income distribution (economic well-being).
 - clearly, in a democratic country, based on the principle of equal opportunity, growing disparity between the “haves and have-nots” would tear at the social fabric and undermine our political cohesion.

- while rapidly changing technologies are a challenge, they also offer solutions to the problems in our educational systems.

Among other benefits of new technologies: faster communications and more powerful computers are leading to greater financial stability through the development and wider use of many new financial instruments referred to as derivatives. While we have all heard horror stories about their misuse, derivatives have given firms new tools for managing their financial risks. This makes it easier for firms to continue to hold risks that they are suited to manage, and to shift to other firms those risks that they are not suited to manage. The result should be that risks, which are inevitable, will be borne by those who are best equipped to handle them. The redistribution of risks will mean that, in general, financial institutions will be safer and sounder.

One way to think about these innovations in financial instruments is like atom-splitting or gene-splicing.

- in wrong hands -- dangerous
- in proper hands -- improvement in our lives

Improved communications and better computers have also played key roles in linking the world's money and capital markets. Now, billions of dollars can be moved from one nation to another in a matter of minutes. Such moves are not capricious but occur in response to changing economic prospects. Economic prospects are often strongly impacted, for good or ill, by wise or short-sighted changes in government policies. This in turn has led financial markets to become what I like to call "financial market vigilantes" who swiftly penalize bad government policies by

moving funds away from the offending countries. [Mexico] In a similar manner, the markets also swiftly reward wise policies. Thus, technology, through discipline of global financial markets, is likely to lead to better government policies.

For example, some people still worry that inflation could return; but another development is making that unlikely.

- 1992/Mexico
- financial market vigilantes;
- general consensus that has developed among central bankers around the world that achieving and maintaining price level stability is the most important goal of monetary policy. (Lincoln)

“no duty is more imperative on that Government, than the duty it owes the people, of furnishing them a sound and uniform currency.” [emphasis added]

In some countries (New Zealand), legislation has even mandated price level stability as the sole objective of the central bank.

There are many examples that could be given of how technological advances will increasingly conserve scarce resources, boost productivity, and enhance living standards. Innovations such as the World Wide Web -- Internet -- will have profound (and, to me, unpredictable) affects on our lives.

Problems: Measurement of Output/Productivity

Growing use of the Web provides a good illustration of an important point: much of the new economic activity that improves our lives is not counted in GDP. For example, much of the information and entertainment obtained from the Web is free. So, while it makes us better off, it does not show up as an increase in real GDP per capita, which is a typical measure of the average standard of living.

In addition, much of what we *do* include in GDP undercounts its contribution to well-being. This is because of the increasing intellectual content of products and services, which makes it easier to have a disparity between the cost of production and the “true” value of the output.

- software diskettes
- durable goods, including PCs
- “Gone With the Wind; Star Wars/Empire Strikes Back/Return of the Jedi”

The shortcomings in using GDP as an indicator of real output and national well-being are not new. But, even though they are not new, they are becoming more significant, I believe, because the proportion of output and consumption that is conceptual rather than physical is increasing at an accelerating pace. So, a measurement problem that 50 years ago was perhaps trivial and certainly was not changing very fast, is now very significant and increasing rapidly.

A related problem is that our accounting conventions cause business spending on items such as computer software, research and development, and workforce training to be expensed

rather than capitalized. Those items typically provide companies with a continued flow of productive services, in the same way that buildings and machines do, but because they are expensed rather than capitalized, they are not considered to be final goods and services and are not included in our measure of GDP.

- introduction of Windows '95 (capital stock) [tomatoes]

Although this shortcoming in our national income and product accounts is not new, it is growing in importance. For example, expenditures on computer software and worker training in its use, which were negligible as recently as a decade ago, are now quite large for most firms.

Thus, the trend toward greater intellectual content in both production processes and output is probably causing an increasing gap between measured GDP and the true value of our economy's output.

In summary, it seems to me that prospects for faster gains in prosperity are exceptionally good. Several important economic, political, and technological forces will work together to accelerate the growth of prosperity during the next 10 to 15 years. To some substantial degree, these forces are already boosting our well-being in ways that our conventional statistics are not capturing.

These are exciting times, especially for those of us who live in America's leading renaissance city! Let's meet our challenges with optimism. Thank you.

Questions and Answers. Now, if there is time, I'll be glad to answer a few questions.