REGIONALISM AND THE FEDERAL RESERVE'S ROLE

Remarks by

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I am delighted to have been asked to participate in this year's annual meeting of the Minnesota Economic Association. It is doubly rewarding because the topic you have decided to concentrate on - regional development - is one to which I have had to give some thought recently. This occasion has forced me to work my way through some of the conceptual thickets that seem to lie in the path of anyone approaching the subject for the first time.

So that you will not be under any false illusions, let me emphasize that regional economics and regional development are not fields in which I pretend to have any expertise. A good number of years ago, I was exposed to the mysteries of international trade theory - and am aware that there is some carryover between the two areas of specialization. But any competence I have in appearing before you today lies in the fact that I have recently taken over the helm of a "regional" institution, the Federal Reserve Bank of Minneapolis, that, by virtue of the interests and skills of my predecessors, has gained a reputation for involvement in the problems and needs of the region it serves. Naturally, I hope to live up to that reputation and further the tradition of service to the region that has become one of our hallmarks.

I have already found, however, that it is much easier to pledge allegiance to the broad goal of regional involvement than it is to lay out a consistent and cohesive program to match deeds to words. One of the explicit goals of the Bank is to find new ways and improve old ways of serving a catalytic role in growth and development of the Ninth District. But I have spent a fair amount of time with my research staff and with my directors over the past few weeks trying to specify the ways in which the Bank could go about attaining that goal, and none of us are satisfied that we have yet found the key to our own regional philosophy.

It is easy enough, of course, to name any number of individual projects that could fit under the heading of "regional development," and a little later I'd like to tell you about some of the things that we have been doing, and are thinking about doing in the future. For the moment though, I'd like to spend some time discussing the reasons why I think we've been having such difficulty in articulating an overall approach or framework for our efforts in this area. Essentially, I think the problem has two quite separate origins: the first has to do with the general state of knowledge, both theoretical and empirical, in the field of regional economics itself; the second has to do with the nature of a Federal Reserve Bank as a regional institution.

Since I disqualified myself at the outset as an expert in the area of regional economics, I feel free to make cavalier pronouncements on the subject, and to show no embarrassment at any lack of originality in their content. Let me state my conclusion right off the bat: when it comes to specifying the goals and means of regional development, I'm not the only one who is confused! In coming to that personally comforting but generally discouraging conclusion, I am relying heavily on a manuscript written at the request of the Minneapolis Fed by Edward Nevin of the University of Wales entitled "Regional Policy and the Role of Banking." We hope to publish Professor Nevin's study in the not too distant future, and I shall not dwell here on his conclusions with respect to the role of banks. I would like to share with you, however, some of his thoughts on the subject of regional development itself; for me, at least, they provided some useful insights.

According to Professor Nevin, the case for a regional policy usually rests on the belief that differences in income levels, unemployment, or rates of growth as between regions ought to be minimized. This case, when so broadly stated, attracts adherents whose particular perspective may be economic, social, or political. The narrower economic justification for a conscious regional policy rests basically on the less than perfect mobility of resources or factors of production which in turn results in the inefficient allocation of resources. In other words, the rationale for a regional policy is to be found in the belief that human intervention can help overcome some of the defects in the normal market mechanism that prevent an efficient spacial distribution of economic activities. In some cases, these imperfections may simply be the product of inertia, ignorance, or perhaps irrationality as they affect private decision-making. In other cases, one can argue that "planning" is necessary to avoid wasteful duplication of investment that might result from "haphazard" private plans. Finally, a case can be made that divergences between private costs, as perceived by the entrepreneur, and the social costs of given projects strengthen the case for regional planning of development efforts. Here, of course we are touching on the issue of external economies and diseconomies that has been receiving - quite justifiably - increasing attention.

Apart from the question of efficiency of allocation, one can argue the economic case for regional development, according to Professor Nevin, on grounds that the existence of economic backwaters, by definition not contributing their share, involve costs to the economy as a whole in terms of foregone growth potential and/or price stability at given levels of aggregate demand.

Against this theoretical case for regional development, one has to weigh the practical costs. Are the costs - economic or social - that result from factor immobility and external effects of sufficient magnitude and duration to justify cranking up a whole development program to deal with them? Or, to put it another way, are we sure that the benefits of artificially stimulated regional development will be greater than the expenditure of the same resources on increasing factor mobility and dealing with the unwanted side effects? These are not easy questions, and unfortunately they are only the first of a series of questions that have to be answered before one can bow before the altar of regional development without qualms. The one thing that is clear is that a good deal more empirical evidence is required before the calculation on cost/benefit can be done.

Professor Nevin points out that there are two basic approaches to the strategy of regional policy formulation. On the one hand, one can aim at resisting, moderating or even reversing the centripetal forces that are causing a particular region to fall behind its neighbors. Or one can take a quite different tack and focus one's efforts on accommodating the economy to the existing forces, hastening the process of concentration - assuming that it reflects the pull of efficient markets - and offsetting the adverse social consequences. The latter approach, while it may sound hardhearted and in some cases simply not be politically practicable, is based on the view that economies of scale and locational advantages exert such a strong pull that they simply can't be overcome without unwarranted expenditures - and indeed should not be overcome in the interests of efficient allocation of resources. As a practical matter, of course, it is not usually possible - or necessary - to choose between these two separate approaches. They can be, and frequently are, pursued side by side - although there is always the risk that they may work against each other in particular situations.

The approach, or combination of approaches, selected will depend to a considerable extent on the nature of the region that one is dealing with, and the goals one is trying to achieve. It takes different policies, for example, if one's main aim is to limit the size of urban centers, than if one's aim is to preserve declining communities. And one can't go very far without running head-on into the conundrum of how best to define the region that one is trying to serve. In the simplest case, one can take existing political boundaries and draw a line around those that seem to form a homogeneous or convenient unit. More satisfying, from an economic point of view, would be the selection of a region on the basis of certain pre-determined characteristics such as low income, high unemployment, and so on. Or one can determine regional boundaries in terms of administrative efficiency - it's obvious that different sorts of tasks can be performed more effectively at different levels of government, though it's more difficult to determine in specific cases the optimal size. As a practical matter, political necessity usually dictates that regions be defined in geographic or administrative terms, even though, as I've indicated, economic characteristics would provide an intellectually more satisfying criterion.

Assuming one has been able to choose an appropriate balance between resisting change and accommodating to it, and has also found an acceptable basis for defining the region to which one wants to minister, there remains the choice among alternative tools or techniques with which to set about the task. Professor Nevin distinguishes four categories or types of governmental actions that have been employed in the pursuit of regional policy objectives. The first is direct action by the government itself. This normally involves investment of public funds in improving the infrastructure of the region's economy. The obvious examples include construction of highways, development of utilities, improvement of housing, etc. One such "investment" that sometimes is omitted from this kind of list is the outlay on education, even though this may well be a region's most valuable resource and drawing card. On the other hand, perhaps this omission simply reflects the fact that too often a region will expend large sums on educating its youth only to see the investment accrue to the advantage of others as the graduates move away. In passing, I think it's interesting to note that development expenditures by public bodies, in this country at least, almost always stop short of investment in commercial enterprises per se, despite the fact that conceptually, such outlays might contribute as much to regional development as, for example, construction of highways.

The second, and perhaps most popular, form of governmental policy to foster development involves inducements of one kind or another to private enterprise to locate in a particular region. Fiscal incentives run the gamut from direct subsidies, to tax foregiveness, to loans on favorable terms. A couple of things should be noted in connection with this type of incentive: first, in contrast with direct government investment on infrastructure which is designed to overcome some of the disadvantages of a particular region, tax inducements are designed to compensate for these disadvantages; second, these inducements usually apply to capital expenditures, thus favoring capital intensive industries that by definition employ relatively few people per unit of output.

Professor Nevin refers to this set of inducement policies as the "carrot" approach, and contrasts them with the less frequently used "stick" approach to regional planning. At the local level, of course, we are all familiar with the zoning ordinances that logically could qualify as development restrictions. But only recently are we seeing zoning-type restrictions applied as a tool of regional development per se. Here I'm thinking of the growing body of restrictions on environmental pollution. In one sense, this is only an extension of the methods for dealing with external diseconomies that have long been a part of the kit used in connection with regional planning. On the other hand, they can also be viewed as a shift in emphasis from development at any price to development, but only in certain ways.

Finally, one should mention the role of local development institutions, designed to aid in the planning and financing of regional development. We have not seen this particular form of institution play a very large role in development efforts to date in this country. But there are a number of bills in Congress that incorporate the development bank approach to regional efforts. Once again, the policy maker does not have to choose one approach to the exclusion of the others, but he should try to arrive at some balance among the approaches on a rational and coordinated basis.

Yet another fundamental choice that has to be made in arriving at a balanced regional policy is whether to distribute the limited resources that can be applied to the effort in an even-handed fashion, providing equal shares to all the participants in the region. Or is it better to take a frankly discriminatory approach, concentrating these resources either on the areas of greatest need, or on the areas of greatest potential economic benefit in terms of becoming viable self-sustaining units. Clearly, these are very difficult questions. In political terms, the easiest answer is to divide up the pie equally among all constituents. But this is by no means the most likely to meet with success in terms of stimulating development over the longer run. Similarly, dealing with the worst first, i.e. those most in need, may simply represent a welfare program rather than a development effort.

These, then, are some of the kinds of choices and decisions that have to be made before we can claim to be working <u>with purpose</u> toward regional development. And by their very nature, these are choices that have to be made by those in political authority. The sad fact is, however, that we seem to be engaged in something we <u>describe</u> as regional development without ever having faced up to these choices. As a result, we shouldn't be surprised that discussions of regional development - and where one element of the economy or another can fit into it - so often end up in confusion. But before we blame politicians for not having done their homework before spending the public's money, let's recognize that we as economists have given the politicians very little guidance, either in laying out the kinds of choices I've tried to describe, or in appraising the relative efficiency of alternative policies. Admittedly, we may be dealing with something of a chicken and egg problem in this regard, since it's hard to measure relative efficiencies when more often than not the ultimate goals of particular policies are only vaguely defined if at all. But I don't think we can get away with that kind of buck passing any longer. I can think of no more worthy task for this meeting and for the work that follows from it, than a concentrated effort to further specify the kinds of choices facing the policy maker in his efforts to deal with regional development, combined with empirical studies that can give guidance to his decisions. For we must acknowledge, I think, that there is no clear consensus at the moment as to the directions that regional development should take, even among those working in the field.

Before turning briefly to the role of the Federal Reserve Bank in the context of regional development, let me share with you the conclusions of Professor Nevin following his catalog of alternatives that I have tried to summarize for you today. He senses among those who have been working in the field of regional development a discouragement with the meagre results that have been achieved through the use of financial inducements to industrial redeployment. This has led to the conclusion that the regional problem "is typically one of fundamental, structural weakness rather than one of stickiness in the labor market." He believes that differences in scale of operations are probably much more important in determining efficiency than differences in location. And if this is so, then it follows that a regional policy not based on the attainment of fairly large-scale centers is not likely to have long-run success. But since this line of argument runs head-on into the political difficulty of concentrating efforts on a few locations, he concludes that regional development efforts are more likely to succeed the higher the level of government involved, and the greater the insulation from direct political pressures. In stating his conclusions, let me say that I am too much of a novice in the field to feel safe in endorsing them, but I am impressed with the apparent logic of his arguments.

If a lack of precision, to put it charitably, characterizes most discussions of regional development, and helps to explain my own difficulty in coming to grips with the issue, how can we in the Federal Reserve nevertheless make a contribution toward meeting an ill-defined, yet deeply felt need to "do something." One part of the answer, I suppose, is obvious. We, no less than you, can make an effort to clear away some of the confusion that impedes purposeful action. In this connection, I hope we can not only publish Professor Nevin's monograph from which I have been drawing, but go on with our studies of various theories and models of regional development in an effort to shed some light on the relative effectiveness of alternative approaches to the problem.

Beyond this obvious link between the Fed and "regional development," how else can we relate to the needs of the District? Perhaps the best place to start is by indicating some of the things that I think we are not equipped to do. For example, the phrase "regional development" frequently implies a specific program for stimulating the economic growth of a particular area <u>through the redirection of resources</u>. I underline the words "through the redirection of resources" because it's too convenient to look only at those who get the resources, and not at those who give them up. In effect, regional development implies, in this context, the favoring of one area <u>at the expense of another</u>. There is nothing wrong with this -- in fact, it's hard to imagine an effective regional policy at the national level that does not involve this kind of "discrimination." But the kinds of choices inherent in such a policy must be made in the political arena, and are not the province of the Federal Reserve. Likewise, and even more obviously, it is not an appropriate role for a Reserve Bank to become an advocate of one section within the district at the expense of another. Yet, this too may well be a legitimate strategy if economic growth is the goal.

If we agree that these kinds of choices are not ones in which the Fed should become involved, it follows, I think, that we cannot participate in any formal economic planning process for the district, since such planning presumably should be the vehicle for decisions on resource reallocation.

Finally, I suppose it should go without saying that the Federal Reserve System, by virtue of its responsibilities in the sphere of monetary policy formulation, is ill-equipped to play a role in financing economic development projects as such.

In ruling out these specific areas as inappropriate for Federal Reserve participation, I think we are still left with a wide field in which to exercise our capabilities and talents on behalf of the District we serve. For if regional development in one sense requires a redistribution of resources from one geographical area to another, it can also be advanced by the more efficient utilization of resources <u>within</u> the region itself. And while the identification of inefficient practices and institutional structures (and recommendations as to preferable alternatives) are not without controversy, they are less likely to involve the kinds of choices that by their nature must be left to elected officials. Simply by trying to anticipate, and seek solutions to, the economic and financial problems of the Ninth District, the Federal Reserve can continue to make a significant contribution to the economy and people of this region.

Let me be more specific. Putting into practice the theory of comparative advantage, we have naturally tended to concentrate our efforts in the field of banking and finance, and presumably will continue to do so. The basic question that we ask ourselves in this context is -- how can existing financial institutions be altered, in their functioning or structure, to provide more efficiently for the capital, credit, and payments needs of the economy in this District? Under this heading, for example, the Bank in the recent past has commissioned a study of the structure of banking in Montana, has participated actively in a System examination of the marketability of agricultural paper, has been collaborating with the University of Minnesota on a program of research and education on the role of capital and credit flows in regional development, has tried to look ahead at the likely structure of banking in the District in the future, and so on. At the same time, as part of a System-wide effort, we have been actively engaged in efforts to improve the efficiency and speed of the payments mechanism itself through expanded use of wire transfers, enlarged regions of same-day payment, consideration of regional clearing centers, and the initiation of check clearance at par throughout the District.

A second area in which the Bank has sought to make a contribution to regional development is through the study of economic conditions in the region itself. One can identify three aspects of this task. In the first place, the Bank helped to sponsor in the early 1960's a basic study by the Upper Midwest Research and Development Council of the broad profile of the Ninth District based on census data available at that time. We are now preparing to finance an update of part of these earlier studies based on the 1970 figures as a means for identifying the changes that have occurred in the region in the last ten years, and the new questions, growing out of these changes, that we ought to be addressing ourselves to in the months and years ahead. Building on the framework of the Upper Midwest studies, we are continuously engaged in taking the economic pulse of the region, in order to be aware of current conditions within the District. The information that results from this continuing survey is of value not only to businessmen operating within the district, but also provides the input on regional conditions that is brought to bear on the process of monetary policy formulation at the monthly Open Market Committee meetings in Washington. Finally, we are engaged in an effort to survey the various models of regional economies that have been developed, in the hopes that one or another, or some adaptation of them, may provide us with a better insight into the functioning of the economic processes in the Ninth District.

In addition to our efforts to understand and improve the financial framework within which the District economy operates, and our interest in economic conditions as such, we believe we can usefully go beyond these areas to other questions concerning the economy of the region that at first sight might seem less directly related to our role as a central bank. As part of this reaching out, I have in mind a range of issue-oriented studies that take the general format of "how best to finance __________." In one sense, of course, this is simply looking at the question of efficient financial structure from the other end of the tube -- not from the point of view of financial institutions and markets, but from the point of view of the publics they serve. I've already mentioned, for example, a couple of projects aimed at the question "how best to finance agriculture." Other areas that suggest themselves as useful candidates to insert in the blank are, say, education at its various levels, or local government. The financing of these social activities are a perennial subject of public debate, and in the context of our self-appointed goal of seeking more efficient use of resources within the District, I think we could make a contribution. As a matter of fact, you may be familiar with a recent study done by Dave Dahl at the Bank and published in our Exponent series stating the case for expanded regional government that focuses on the inefficiency of small and overlapping jurisdictions.

Because I think our natural advantage in the field of economic research lies in the areas of finance and capital markets and broad economic analysis, it seems reasonable to concentrate our efforts, when we do step outside these areas, on questions of financing such as I've just described. But even here I would not want to feel that our horizons were closely circumscribed. There could well be issues of concern to the economy of the region that do not fall neatly under this heading, yet seem to be neglected by other research-oriented groups. Within the limits of our own resources, I think we should be prepared to step in. One example of this sort of study was the look we took a while ago at the international trade potential of the District.

You may have noticed the omission from my catalog of priorities of any reference to marketing studies. This was quite deliberate. The kind of staff and expertise required to stay current with the market situation for a broad range of commodities is frankly beyond our means and beyond our scope of interests. At the same time, I think we should explore the possibility of acting as a clearinghouse for directing questions of this nature to the best source for an answer.

Time and again in describing the ways in which the Bank can make a contribution to improving the regional economy, I have referred to studies and research efforts. Obviously this is where we have to begin -- by identifying problems and issues and then investigating them. But just as obviously, this is not where our efforts can stop. If we are to see our studies result in change -- which, after all, is what we are ultimately seeking -- we've got to let people know what we think. And this implies publication of our views, and a conscious program of economic education within the District through meetings and roundtable discussions. And indeed, in certain circumstances, I think we should not be afraid to become insistent advocates for a particular point of view.

None of this is particularly new -- the Minneapolis Fed has been undertaking these kinds of activities for some time -- but the emphasis, in the regional context at least, is shifting from descriptive studies, to issue-oriented questions. Nor do we consider ourselves as having a monopoly on wisdom in this area -- far from it. You, as professors, for example, are engaged in much the same kinds of activities day in and day out. And indeed, it is for this reason that I think we ought to try to work together wherever possible so that our efforts complement one another in our mutual search for ways of improving the performance of the economy of this region. I would welcome from you suggestions as to the topics that ought to rank high in our own research efforts, given the Federal Reserve's priorities and talents as I've tried to outline them today.

In summary, the Federal Reserve Bank of Minneapolis is a regional institution that takes its regional role seriously. I see that role as best carried out through the identification of problem areas and inefficient institutional structures, followed up by a search for solutions and better ways of doing things. I believe we can better contribute to regional development through an approach that seeks to resolve problems than through an effort to seek ways of stimulating growth as such. The proof of this proposition will only be seen in our accomplishments. I welcome you to join us in the effort.