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Remarks by

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As the Great Depression of the 1930s deepened, John Maynard Keynes offered an explanation for the then-bewildering series of events that was to engage economists for generations to come. Market systems, he argued, contrary to the conventional wisdom, did not at all times converge to full employment. They often, in economists' jargon, found equilibrium with significant segments of the workforce unable to find jobs. His insight rested largely on certain perceived rigidities in labor and product markets. The notion prevalent in the 1920s and earlier--that economies, when confronted with unanticipated shocks, would quickly return to full employment--fell into disrepute as the depression festered. In its place arose the view that government action was required to restore full employment.

More broadly, government intervention was increasingly seen as necessary to correct the failures and deficiencies viewed as inherent in market economies. Laissez-faire was rapidly abandoned and a tidal wave of regulation swept over much of the world's business community. In the United States, labor practices, securities issuance, banking, agricultural pricing, and many other segments of the American economy, fell under the oversight of government. With the onset of World War II, both the U.S. and the U.K. economies went on a regimented war footing. Military production ramped up rapidly and output reached impressive levels. Central planning, in one sense, had its finest hour. The pattern of production and distribution depended on plans devised by a small, elite group rather than responding to the myriad choices of consumers that rule a market economy.

The ostensible success of wartime economies operating at full employment, in contrast to the earlier frightening developments of the depression years, thwarted a full dismantlement of wartime regimens when hostilities came to an end. Wage and price controls, coupled with rationing, lingered in many economies well into the first postwar decade. Because full employment was no longer perceived as ensured by the marketplace, government initiatives promoting job growth dominated the postwar economic policy framework of the Western democracies. In the United States, the Congress passed, and the President signed, the "Employment Act of 1946."

However, cracks in the facade of government economic management emerged early in the postwar years, and those cracks were to continue widening as time passed. Britain's heavily controlled economy was under persistent stress as it vaulted from one crisis to another in the early postwar decades. In the United States, unbalanced macroeconomic policies led to a gradual uptrend in the rate of inflation in the 1960s. The imposition of wage and price controls in the 1970s to deal with the problem of inflation proved unworkable and ineffective. The notion that the centrally planned Soviet economy was catching up with the West was, by the early 1980s, increasingly viewed as dubious, though it was not fully discarded until the collapse of the Berlin Wall in 1989 exposing the economic ruin behind the iron curtain.

The East-West divisions following World War II engendered an unintended four-decades-long experiment in comparative economic systems, which led, in the end, to a judgment by the vast majority of policymakers that market economies were unequivocally superior to those managed by central planning. Many developing nations abandoned their Soviet-type economic systems for more market-based regimes.

But even earlier in the developed world, distortions induced by regulation were more and more disturbing. In response, starting in the 1970s, American Presidents, supported by bipartisan majorities in the Congress, deregulated large segments of the transportation, communications, energy, and financial services industries. The stated purpose was to enhance competition, which was increasingly seen as a significant spur to productivity growth and elevated standards of living. Assisting in the dismantling of economic rigidities was the seemingly glacial, but persistent, lowering of barriers to cross-border trade and finance.

As a consequence, the United States, then widely seen as a once great economic power that had lost its way, gradually moved back to the forefront of what Joseph Schumpeter, the renowned Harvard professor, called "creative destruction," the continuous scrapping of old technologies to make way for the innovative. In that paradigm, standards of living rise because depreciation and other cash flows of industries employing older, increasingly obsolescent, technologies are marshaled, along with new savings, to finance the production of capital assets that almost always embody cutting-edge technologies. Workers, of necessity, migrate with the capital.

Through this process, wealth is created, incremental step by incremental step, as high levels of productivity associated with innovative technologies displace lesser productive capabilities. The model presupposes the continuous churning of a flexible competitive economy in which the new displaces the old.

The success of that strategy in the United States confirmed, by the 1980s, the earlier views that a loosening of regulatory restraint on business would improve the flexibility of our economy. Flexibility implies a faster response to shocks and a correspondingly greater ability to absorb their downside consequences and to recover from their aftermath. No specific program encompassed and coordinated initiatives to enhance flexibility, but there was a growing recognition, both in the

United States and among many of our trading partners, that a market economy could best withstand and recover from shocks when provided maximum flexibility.

Developments that enhanced flexibility ranged far beyond regulatory or statutory change. For example, employers have long been able to legally discharge employees at modest cost. But in the early postwar years, profitable large corporations were dissuaded from wholesale job reduction. Contractual inhibitions, to be sure, were then decidedly more prevalent than today, but of far greater importance, our culture in the aftermath of depression frowned on such action. Only when bankruptcy threatened was it perceived to be acceptable.

But as the depression receded into history, attitudes toward job security and tenure changed. The change was first evidenced by the eventual acceptance by the American public of President Reagan's discharge of federally employed air traffic controllers in 1981 when they engaged in an illegal strike. Job security, not a major concern of the average worker in earlier years, became a significant issue especially in labor negotiations. By the early 1990s, the climate had so changed that laying off workers to facilitate cost reduction had become a prevalent practice. Whether this seeming greater capacity to discharge workers would increase or decrease the level of structural unemployment was uncertain, however. In the event, structural unemployment decreased because the broadened freedom to discharge workers rendered hiring them less of a potentially costly long-term commitment.

The increased flexibility of our labor market is now judged an important contributor to economic resilience and growth. American workers, to a large extent, see this connection and, despite the evident tradeoff between flexibility and job security, have not opposed innovation. An appreciation of the benefits of flexibility also has been growing elsewhere. Germany recently passed labor reforms, as have other continental European nations. U.K. labor markets, of course, have also experienced significant increases in flexibility in recent years.

Beyond deregulation and culture change, innovative technologies, especially information technology, have been major contributors to enhanced flexibility. A quarter-century ago, companies often required weeks to unearth a possible inventory imbalance, allowing production to continue to exacerbate the excess. Excessive inventories, in turn, necessitated a deeper decline in output for a time than would have been necessary had the knowledge of their status been fully current. The advent of innovative information technologies has significantly foreshortened the reporting lag, enabling flexible real-time responses to emerging imbalances.

Deregulation and the newer information technologies have joined, in the United States and elsewhere, to advance *financial* flexibility, which in the end may be the most important contributor to the evident significant gains in economic stability over the past two decades.

Historically, banks have been at the forefront of financial intermediation, in part because their ability to leverage offered an efficient source of funding. But too often in periods of severe financial stress, such leverage brought down numerous, previously vaunted banking institutions, and precipitated a financial crisis that led to recession or worse. But recent regulatory reform coupled with innovative technologies has spawned rapidly growing markets for, among many other products, asset-backed securities, collateral loan obligations, and credit derivative default swaps.

Financial derivatives, more generally, have grown throughout the world at a phenomenal rate of 17 percent per year over the past decade. Conceptual advances in pricing options and other complex financial products, along with improvements in computer and telecommunications technologies, have significantly lowered the costs of and expanded the opportunities for hedging risks that were not readily deflected in earlier decades. The new instruments of risk dispersion have enabled the largest and most sophisticated banks in their credit-granting role to divest themselves of much credit risk by passing it to institutions with far less leverage. Insurance companies, especially those in reinsurance, pension funds, and hedge funds continue to be willing, at a price, to supply this credit protection, despite the significant losses on such products that some of these investors experienced during the past three years.

These increasingly complex financial instruments have contributed, especially over the recent stressful period, to the development of a far more flexible, efficient, and hence resilient financial system than existed just a quarter-century ago. One prominent example was the response of financial markets to a burgeoning and then deflating telecommunications sector. Worldwide borrowing by telecommunications firms in all currencies amounted to more than the equivalent of one trillion U.S. dollars during the years 1998 to 2001. The financing of the massive expansion of fiber-optic networks and heavy investments in third-generation mobile-phone licenses by European firms strained debt markets.

At the time, the financing of these investments was widely seen as prudent because the telecommunications borrowers had very high valuations in equity markets, which could facilitate a stock issuance, if needed, to pay down bank loans and other debt. In the event, of course, prices of telecommunications stocks collapsed, and many firms went bankrupt. Write-downs were heavy, especially in continental Europe, but unlike in previous periods of large financial distress, no major financial institution defaulted, and the world economy was not threatened. Thus, in stark contrast to many previous episodes, the global financial system exhibited a remarkable ability to absorb and recover from shocks.

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The most significant lesson to be learned from recent economic history is arguably the importance of structural flexibility and the resilience to economic shocks that it imparts. The more flexible an economy, the greater its ability to self-correct in response to inevitable, often unanticipated, disturbances and thus to contain the size and consequences of cyclical imbalances. Enhanced flexibility has the advantage of being able to adjust automatically and not having to rest on policymakers' initiatives, which often come too late or are misguided.

I do not claim to be able to judge the relative importance of conventional stimulus and increased economic flexibility to our ability to weather the shocks of the past few years. But it is difficult to dismiss improved flexibility as having played a key role in the U.S. economy's recent relative stability. In fact, the past two recessions in the United States were the mildest in the postwar period. The experience of Britain and many others during this period of time have been similar.

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I do not doubt that the vast majority of us would prefer to work in an environment that was less stressful and less competitive than the one with which we currently engage. The cries of distress amply demonstrate that flexibility and its consequence, rigorous competition, are not universally embraced. Flexibility in labor policies, for example, appears in some contexts to be the antithesis of job security. Yet, in our roles as consumers, we seem to insist on the low product prices and high quality that are the most prominent features of our current frenetic economic structure. If a producer can offer quality at a lower price than the competition, retailers are pressed to respond because the consumer will otherwise choose a shopkeeper who does. Retailers are afforded little leeway in product sourcing and will seek out low-cost producers, whether they are located in Guangdong province in China or northern England.

If consumers are stern taskmasters of their marketplace, business purchasers of capital equipment and production materials inputs have taken the competitive paradigm a step further and applied it on a global scale.

From an economic perspective, the globe has indeed shrunk. Not only have the costs of transporting goods and services, relative to the total value of trade, declined over most of the postwar period, but international travel costs, relative to incomes, are down, and cross-border communications capabilities have risen dramatically with the introduction of the Internet and the use of satellites. National boundaries are less and less a barrier to trade as companies more and more manufacture in many countries and move parts and components across national boundaries with the same ease of movement exhibited a half century ago within national economies. A consequence, in the eyes of many, if not most, economists, world per capita real GDP over the past three decades has risen almost 1-1/2 percent annually, and the proportion of the developing world's population that live on less than one dollar per day has markedly declined.

Yet globalization is by no means universally admired. The frenetic pace of the competition that has characterized markets' extended global reach has engendered major churnings in labor and product markets.

The sensitivity of the U.S. economy and many of our trading partners to foreign competition appears to have intensified recently as technological obsolescence has continued to foreshorten the expected profitable life of each nation's capital stock. The more rapid turnover of our equipment and plant, as one might expect, is mirrored in an increased turnover of jobs. A million American workers, for example, currently leave their jobs every week, two-fifths involuntarily, often in association with facilities that have been displaced or abandoned. A million, more or less, are also newly hired or returned from layoffs every week, in part as new facilities come on stream.

Related to this process, jobs in the United States have been perceived as migrating abroad over the years, to low-wage Japan in the 1950s and 1960s, to low-wage Mexico in the 1990s, and most recently to low-wage China. Japan, of course, is no longer characterized by a low-wage workforce, and many in Mexico are now complaining of job losses to low-wage China.

In developed countries, conceptual jobs, fostered by cutting-edge technologies, are occupying an ever-increasing share of the workforce and are gradually replacing work that requires manual skills. Those industries in which labor costs are a significant part of overall costs have been under greater competition from foreign producers with lower labor costs, adjusted for productivity.

This process is not new. For generations human ingenuity has been creating industries and jobs that never before existed, from vehicle assembling to computer software engineering. With those jobs come new opportunities for workers with the necessary skills. In recent years, competition from abroad has risen to a point at which developed countries' lowest skilled workers are being priced out of the global labor market. This diminishing of opportunities for such workers is why retraining for new job skills that meet the evolving opportunities created by our economies has become so urgent a priority. A major source of such retraining in the United States has been our community colleges, which have proliferated over the past two decades.

We can usually identify somewhat in advance which tasks are most vulnerable to being displaced by foreign or domestic competition. But in economies at the forefront of technology, most new jobs are the consequence of innovation, which by its nature is not easily predictable. What we in the United States do know is that, over the years, more than 94 percent of our workforce, on average, has been employed as markets matched idled workers seeking employment to new jobs. We can thus be confident that new jobs will displace old ones as they always have, but not without a high degree of pain for those caught in the job-losing segment of America's massive job-turnover process.

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The onset of far greater flexibility in recent years in the labor and product markets of the United States and the United Kingdom, to name just two economies, raises the possibility of the resurrection of confidence in the automatic rebalancing ability of markets, so prevalent in the period before Keynes. In its modern incarnation, the reliance on markets acknowledges limited roles for both countercyclical macroeconomic policies and market-sensitive regulatory frameworks. The central burden of adjustment, however, is left to economic agents operating freely and in their own self-interest in dynamic and interrelated markets. The benefits of having moved in this direction over the past couple of decades are increasingly apparent. The United States has experienced quarterly declines in real GDP exceeding 1 percent at an annual rate on only three occasions over the past twenty years. Britain has gone forty-six quarters without a downturn.

Nonetheless, so long as markets are free and human beings exhibit swings of euphoria and distress, the business cycle will continue to plague us. But even granting human imperfections, flexible economic institutions appear to significantly ameliorate the amplitude and duration of the business cycle. The benefits seem sufficiently large that special emphasis should be placed on searching for policies that will foster still greater economic flexibility while seeking opportunities to dismantle policies that contribute to unnecessary rigidity.

Let me raise one final caution in this otherwise decidedly promising scenario.

Disoriented by the quickened pace of today's competition, some in the United States look back with nostalgia to the seemingly more tranquil years of the early post-World War II period, when tariff walls were perceived as providing job security from imports. Were we to yield to such selective nostalgia and shut out a large part, or all, of imports of manufactured goods and produce those goods ourselves, our overall standards of living would fall. In today's flexible markets, our large, but finite, capital and labor resources are generally employed most effectively. Any diversion of resources from the market-guided activities would, of necessity, engender a less-productive mix.

For the most part, we in the United States have not engaged in significant and widespread protectionism for more than five decades. The consequences of moving in that direction in today's far more globalized financial world could be unexpectedly destabilizing.

I remain optimistic that we and our global trading partners will shun that path. The evidence is simply too compelling that out mutual interests are best served by promoting the free flow of goods and services among our increasingly flexible and dynamic market economies.