2. WHERE ARE WE?
A CONTEXT FOR STRATEGIC PLANNING

HOW OREGON IS CHANGING

Over the next two decades, Oregon will undergo tremendous change. Already, global competition and trade are increasing pressure on Oregon companies to innovate and cut costs, and at the same time to open new markets. New market opportunities are particularly promising given the state's position along the Pacific Rim and between the dynamic economies of Puget Sound and California. Innovations in technology will expand Oregon's access to information, alter our manufacturing industries, and inspire a diverse array of new products. The state will continue to invest in and harvest economic benefits from natural resources. Yet it is clear -- and it has been for some time, even before the recent controversy over federal timber harvest levels -- that natural resources will not be a leader in employment growth and will not drive Oregon's economy into the next century.

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Whether these changes will impact our economy for good or ill will depend in large part on how Oregon responds. In the pages that follow, we look at these changes with an eye to the challenges and implications they present for the state economy and the economic strategy proposed in this document.

OREGON'S ECONOMIC TRANSITION

Oregon's economy is in a process of far-reaching transition. Traditionally, the economy has relied heavily on its natural resources as a major source of jobs, income, and wealth. Our natural resources are renewable and will continue to be an important source of economic activity. However, to maintain levels of employment and raise incomes of Oregonians, the state over the next 20 years must diversify increasingly into products and services that rely more heavily on human knowledge and talent.

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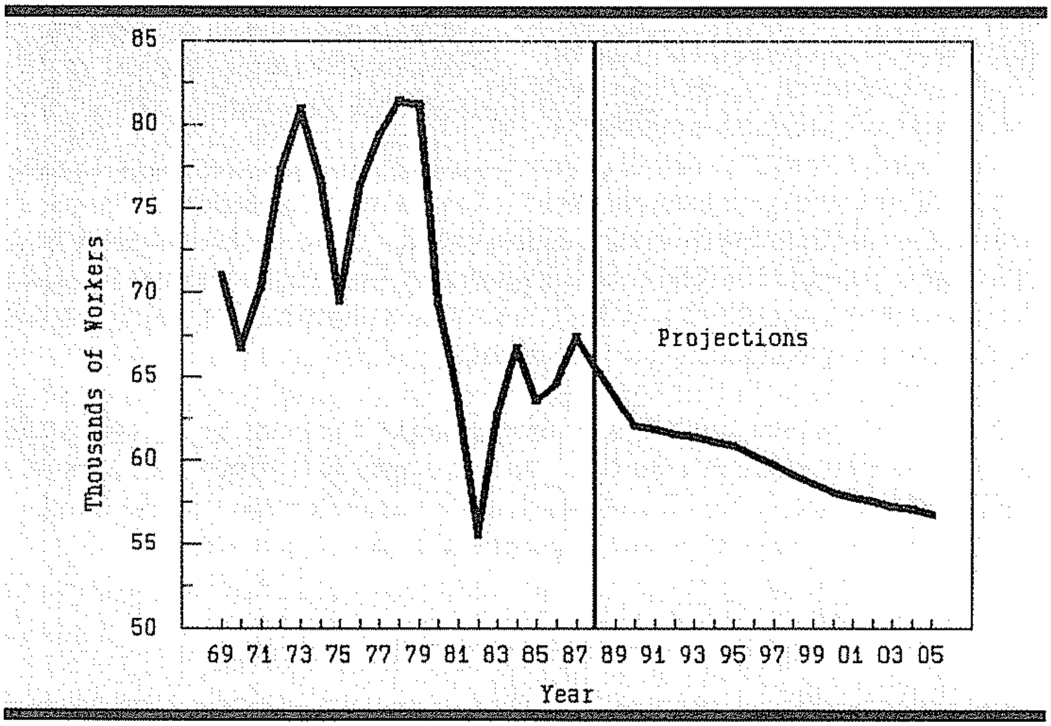
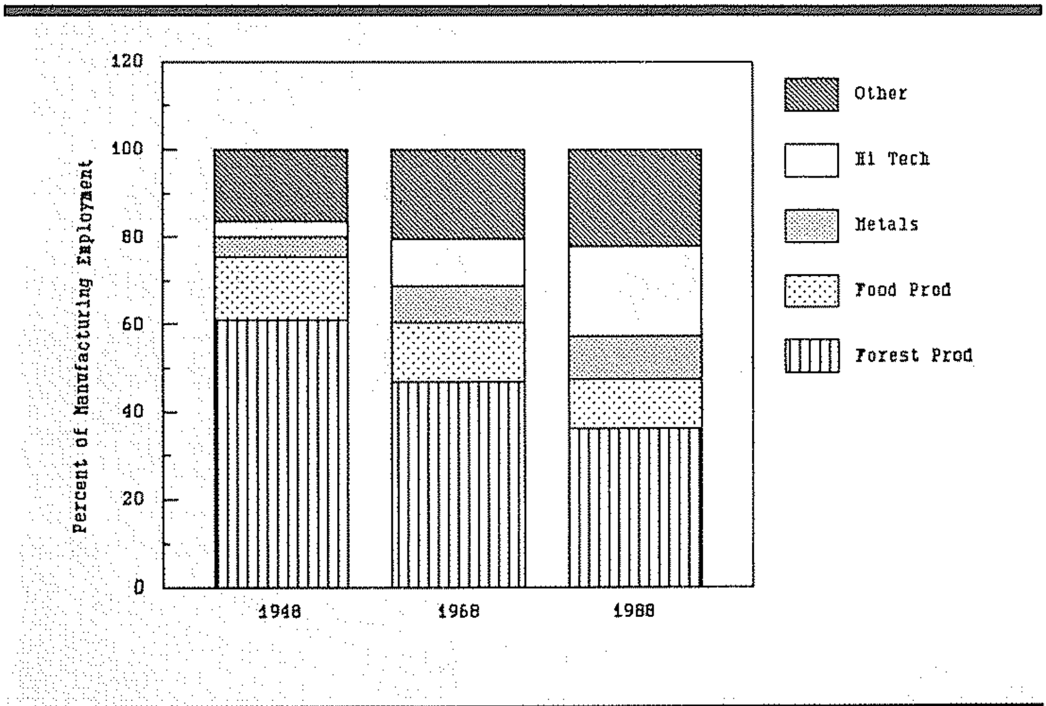
Under the best of circumstances, employment in forest products, Oregon's largest industry, is likely to decline over the next decade. Disregarding the cyclical ups and downs of the industry, 13,000 well paying jobs in forest products have been lost permanently in the last ten years due to changes in timber harvest levels, log exports, and productivity improvements in mills. An equal number of jobs could be lost permanently over the next two decades as a result of these long-term trends. (See Figure I-1.) Recognition of these trends does not mean the state is turning its back on natural resources. Rather, it signals that we are being realistic in the way we move forward.

Figure I-1. Forecast for Oregon lumber and wood products employment. The trend is down.



Fortunately, since World War II, Oregon has been gradually diversifying. Figure I-2 illustrates this trend. The share of manufacturing based on natural resources has steadily declined. During most of the postwar period, employment growth in Oregon rose steadily, exceeding the national average. However, during much of the 1980s, diversification stalled while forest products entered a severe downturn, and the economy entered the worst recession by far since the Great Depression. The economic distress experienced this decade in Oregon has been painful for both individuals and communities. A per capita income that exceeded the national average in the late 1970s was hit so hard that it still languishes 8 percent below the national average. (See Figure I-3.) Real annual wages in Oregon dropped during the 1980s while increasing in the United States overall. (See Figure I-4.) During the 1970s people moved into Oregon in record numbers, attracted by jobs and our widely heralded quality of life. During the first half of the 1980s, we lost population as jobs disappeared and people moved away. Even with the recent upturn, in many communities in Oregon there are fewer jobs today than there were ten years ago, and many of the jobs that are left pay less. Communities themselves are in financial distress as they try to finance schools, roads, and services on a smaller economic base. State Government, too, deferred maintenance during the downturn, and now must catch up on everything from prisons to mental health to university facilities. As a result, we haven't built sufficient capacity in our services and infrastructure to capitalize on the economic benefits of growth when it resumes.

Figure I-2. Oregon industries since 1948. Gradual diversification.



Even within prosperous regions of the state, many families face financial distress caused by shifting job opportunities. Most disturbing, an increasing number of children are growing up in poverty because their parents are not able to find jobs that pay well. Economic frustrations contribute to higher levels of family instability, placing children at higher risk -- diminishing their development as healthy adults and productive citizens. While this robs us of productive capacity, it simultaneously burdens our communities and citizens, draining our social service agencies, our criminal justice system, and our tax dollars. Such factors threaten our ability to maintain a strong middle class, which is central to our social and economic stability.

Figure I-3. U.S. and Oregon per capita income. Still 8 percent below the national average.

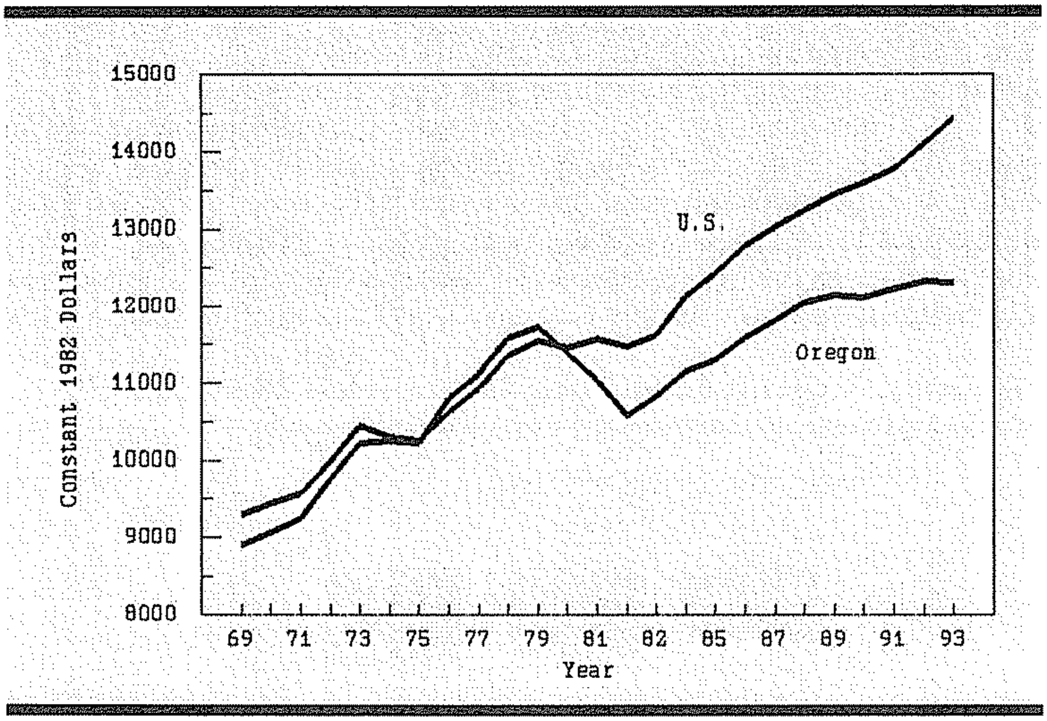
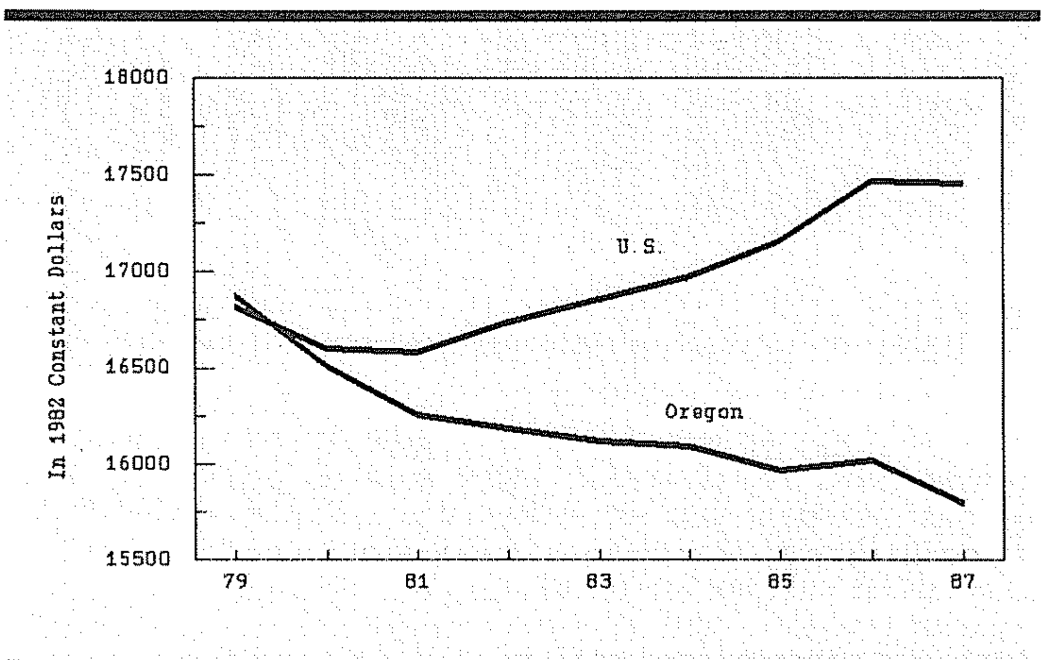


Figure I-4. Real annual wages. Up for the nation; down for Oregonians.



The recession in the early 1980s was unusually severe. We still are catching up to rebuild the facilities and services that were deferred during that period. Moreover, the forest products industry still faces reductions in employment due to long-term declines in timber supply and productivity improvements. Yet with the rapid growth that has occurred over the past two years, we are now able to look ahead with much greater confidence. Despite adjustments in our resource-based industries, they remain durable. In addition, we can expect the kind of diversification that has occurred throughout the post-war period to continue. Our challenge is to diversify into activities that pay well and to do so on a statewide basis.

WE HAVE GOOD NEIGHBORS

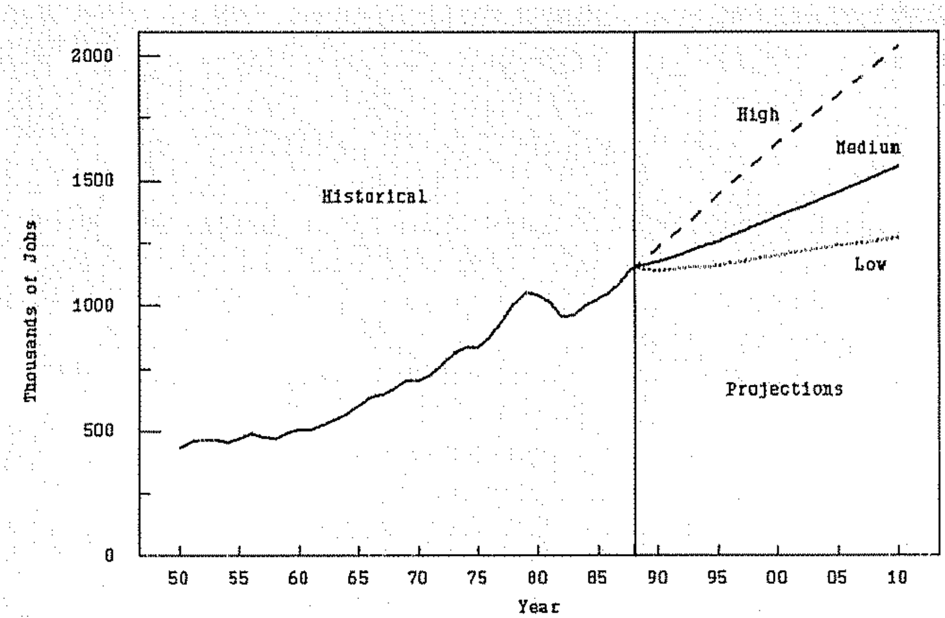
Beyond these internal dynamics, Oregon's economy in the next two decades will be shaped by external trends that offer both challenges and opportunities. Among these trends, perhaps the most obvious and the most promising is the growth of the economies around us. The 21st Century is expected to become the "Pacific Century," presenting remarkable opportunity for Oregon. Economies along the Pacific Ocean -- including those in the western United States -- are the most rapidly growing in the world. And while international trade has been growing in general, the most rapid growth has been across the Pacific. Trade between the United States and Pacific Rim nations now surpasses U.S.-foreign trade across the Atlantic.

During the era when most U.S. trade occurred within the United States, Oregon was badly located at a sparsely populated corner of the country. Now, from the perspective of the Pacific Rim, Oregon is much better positioned. Perhaps the greatest opportunity along the Pacific Rim is trade with our nearest neighbors, Washington and California. The U.S. population, and with it the forces of economic growth, are shifting westward. California's economy is the strongest in the nation, and the Puget Sound economy is robust. Oregon is in an ideal position to serve these markets. At the same time, we can attract businesses which want to locate near them but avoid their problems (for example, growing congestion, industry-specific taxes, or regulatory disincentives). Indeed, because Oregon is so well positioned on the West Coast, with major transportation corridors to both Washington and California, it is almost inevitable that we will grow. Certain companies will locate here to enjoy our comparative advantages and sell their products into the growing economies to our north and south. By all scenarios, the Northwest Power Planning Council forecasts employment growth the next two decades (See Figure I-5.)

> ***...it is almost inevitable that we will grow...that growth will be determined in part by how we shape our competitive advantages...***

This raises two key and interconnected questions: What kind of growth will we have, and what comparative advantages will companies see in us? Growth could come in the form of low-wage production, or it could come in sophisticated manufacturing and service companies. The nature of the growth will be determined in part by how we shape our competitive advantages on the West Coast.

Figure I-5. Oregon's historical and projected employment growth. Up by all scenarios.



Sources: Historical data from Oregon Employment Division
Projections from Northwest Power Planning Council

Beyond our nearest neighbors, growth along the Pacific Rim is creating important opportunities for trade with Asian nations. Oregon has already invested heavily in developing ties with Asia. Several Japanese companies have located here, and Oregon companies have successfully tapped Asian markets. Trade flows have increased through Oregon ports, most notably for automobiles. This trade is still in its infancy, however. The way we position ourself to take advantage of the Pacific Rim will greatly shape our future over the next 20 years.

THE GLOBAL CHALLENGE

The growth of the Pacific Rim is part of a broader trend. In the course of less than two decades, the United States has found itself facing greater competition from foreign businesses than ever before. Few industries within the U.S. are immune from international competition, either from advanced nations (who often employ sophisticated manufacturing and talented labor) or from newly developing countries (who increasingly mass produce goods with low paid labor). As this competition has increased, so has the flow of goods and services among countries. Further integration of the world's developed economies will continue along much the same lines as in the past two decades -- more competition, more transnational production, greater financial interdependency.

The implications of globalization are enormous. U.S. companies must compete not just with each other, but with companies from different economies with different costs of capital, different qualities and costs of labor, different traditions of labor-management relations, and different relationships between the public and private sectors. In short, the United States is in competition with other economic systems which often have significant productive advantages.

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Diagnosing the competitiveness of the U.S. in a global economy has itself become a growth industry during the 1980s. Despite strong employment growth in the U.S. economy, a huge trade deficit, stagnant wages, growing disparities in income and wealth, and mounting levels of government, corporate, and consumer debt all raise troubling questions about the ability of this country to compete in a global economy. Analysts comparing the U.S. economy with the economies of other nations, raise three key concerns, each of which has implications for Oregon.

First, tremendous federal deficits and the growth of corporate and consumer debt has raised the cost of capital compared with that of other nations. This gives nations like Japan and Germany a major competitive advantage in investing in research and new equipment.

Second, military spending during the Reagan years reached record levels. Whatever the merits of the defense buildup, the large expenditures have added to the debt burden, and equally important, reduced the availability of funds to invest in infrastructure, education, and research. The dearth of investment in these areas may well place the United States at a competitive disadvantage in the years ahead.

Third, and perhaps most troubling, comparisons of the United States work force with those of other nations generally have shown the United States to be at serious disadvantage. In math and science skills, in knowledge of foreign languages, cultures, and geography, and in other skills, the U.S. population as a whole does not compare favorably to other industrial and many newly industrial nations. Children in the United States spend less time in school, and apparently are not as prepared for work as graduates in other nations. This trend is especially disturbing given the importance of fundamental skills in driving the economy of the future.

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Oregon shares these problems. Our economy has long been tied to the U.S. economy, most prominently through the connection of the forest products industry to housing construction, and the vulnerability of that business to interest rates. The growing national debt, combined with Federal Reserve Board monetary policy, increases the possibility of higher interest rates and a plunge in housing starts sometime on the horizon.

Due to the depth of the last recession in Oregon, we have invested even less in infrastructure than other regions of the United States. Potentially, we face a more serious infrastructure problem than the nation as a whole. As a matter of policy, the "Reagan Revolution" reduced aid to states for everything from infrastructure to education to aid for impoverished families. Combined with that legacy, huge federal budget deficits reduce the likelihood of much support coming to states through federal programs in the near future. In fact, we are likely to see further reductions in federal programs. Confronted with substantial needs to provide infrastructure, more than any time in recent history, Oregon is on its own.

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Perhaps our most serious concern should be the quality of our work force. Oregon's work force appears to be, at best, only marginally superior to the rest of the United States. Therefore, we face the same competitive challenge in work force capacity that confronts the rest of the nation. If we want to compete successfully not just with other states but also with other nations, we must invest in producing a superior work force.

While the growth of international trade creates challenges, it also creates opportunities, especially for Oregon. New markets emerge from international trade, creating opportunities for growth and expansion to those who learn how to sell overseas and respond quickly to changing opportunities. Foreign trade also increases opportunities for attracting foreign investment. Those regions of the United States whose citizens are conversant in foreign cultures, languages, and markets will have a significant advantage not only in the race to serve global markets but also in the effort to attract international investment.

THE TECHNOLOGICAL REVOLUTION

On a fundamental level, computers, telecommunications, materials sciences, genetic engineering, and robotics are shaping a new economy. This emerging "information economy" is displacing the urban manufacturing economy in much the same way that manufacturing supplanted the rural agricultural economy a century ago. While this development by no means suggests that manufacturing will not continue to be a vital part of the economy, it does suggest that employment in this sector is likely to decrease as new technology replaces traditional manufacturing jobs. It also suggests that in the manufacturing economy, those who know how to deploy and utilize new technology will have a competitive advantage in the future.

The new economy does not yet have a well-defined set of rules, but those are evolving. As they do, there will be basic changes in all aspects of our culture, analogous to the previous shifts from a rural agrarian society to an urban industrial society. We will see differences in values, lifestyles, corporate structures, institutions, and politics.

The information economy will affect different industries in different ways. In manufacturing, new technologies will permit specialty (as opposed to mass) production of customized goods on a smaller scale. New technologies will automate much of commodity production. So-called "smart" products, those made by flexible, skilled work groups will become much more valuable (and employ more people) than commodities. Demand for highly-skilled, technical workers will rise, while opportunities for semiskilled and unskilled workers will decrease.

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This will present three challenges to Oregon's economy. First, those economies that are inventing new technologies and processes are more likely to diffuse such technologies into practical applications than those that do not. Therefore, it is vitally important that the State System of Higher Education and other research institutions be at the leading edge of research in technology and manufacturing processes, and that the research be transferred into the private sector. Second, the quality of the work force will play a key role in determining which regions will apply advanced technology. A region whose work force has strong basic skills and specialized training will enjoy a competitive advantage and command higher wages. Third, we must prepare for a future in which relatively smaller, specialized companies are likely to be the greatest source of growth in the economy, rather than companies that rely on mass production technology. In Oregon during the 1980s, a study by the Economic Development Department concludes, the overwhelming source of new jobs came from small business. While large companies will continue to be important, states that recognize the needs of smaller companies are more likely to prosper in the future.

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WHAT WE MUST DO

The external trends described above underscore the importance of a strategy to sustain growth. We must decide together that we want the better future we can have, and we must make decisions about where and how much to invest in that future -- in eduction and public services, in infrastructure, and in our commerce with the rest of the world. We must boost the economy along its path to diversification. We must produce a wider array of products. We must market these products beyond our borders.

The way we diversify will be as important to us as diversification itself. First, we must build an economy where knowledge and skill have productive value. In the new global economy, capital and manufacturing technology have become increasingly mobile. As a result, production that can utilize low-skilled labor can and often does move to regions of the world where labor is cheap. In part, that is why the average number of employees in U.S. manufacturing plants has declined. Firms have either added new technology to increase manufacturing efficiency, or production has shifted off shore. Conversely, those regions that prosper with high wages will be those that employ highly skilled people to design and market new products or which employ production processes which rely on skilled labor. In a global economy, there will be few jobs requiring limited skills that pay high wages. Second, we must increase our understanding of global markets and how to do business with people in those markets. Economies with

> ***...we must build an economy where knowledge and skill have productive value...***

people educated in foreign cultures and languages will be better able to identify global opportunities, and market products accordingly.

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Finally, those who have a role in shaping our state economy must fashion closer cooperative working relationships as we begin to compete in global markets. The underlying cooperation between institutions within an economy is an important source of competitive advantage. Study after study stresses the competitive advantage Japan enjoys from its close cooperation between government, business, labor, and education. The United States is finding its tradition of adversarial relations among institutions to be a competitive disadvantage as it steps up its participation in global business.

In sum, those regions that are successful in providing well paying jobs in the future will have well educated, adaptive people who can employ new technology and do business globally. Those regions in which business, government, labor and education work together in the development of the economy will enjoy a competitive advantage. Both of these principles need to be incorporated in Oregon's strategy for economic growth.