The Economy
U.S. Economy Hampered by a Lack of Producers

MINNEAPOLIS STAR TRIBUNE -- January 20, 1991

Need evidence that our economy is sick? Check these conditions:

• Unprecedented consumer debt;
• Government deficits several times the amount formerly regarded as astronomical;
• The quick transition of the United States from the world's largest creditor to its largest debtor;
• Volatile capital markets;
• Monumental trade deficits;
• And a plethora of unfriendly and under-analyzed corporate takeovers.

The time is long past where we need more insightful analysis about what ails the economy. Our present analytical methods are not bringing results.

As with many other socio-technical system problems, questions surface regarding the cause of economic difficulties. Is it the lagging character of production capability? Or, is it the increasing burden it must bear? Should production be increased? Or is it necessary to reduce the expenditures of the non-producing part of the system?

Manufacturing and other forms of tangible production, along with essential maintenance services, provide the real economic wealth of the nation, for all of its people. The future of the U.S. economy is inescapably tied to the efficiency and quality of its tangible production. In the interest of economic stability, a more favorable balance must be developed between production and consumption.

Yet, in the past 40 years we have witnessed a falling appreciation for tangible production (manufacturing, construction and mining). We have neglected it to concentrate on other things. In 1900, 48 percent of the nonagricultural labor force was engaged in tangible production. Even as late as 1950, this figure was still at 41 percent. By 1988, it had dropped to 24 percent. And the U.S. government has issued a projection that it will be 21 percent by the year 2000.

Meanwhile, employment in finance, insurance, real estate, government and services (gross national overhead) has mushroomed from 13 million people in 1950 to 32 million today. Minnesota continues in the same vein. During the past two years, the state has lost 13,800 manufacturing jobs but added 20,700 government jobs.

The problem of gross national overhead goes far beyond government, however. We are all part of it. Finance, insurance and real estate employment has more than tripled since 1950. Service employment has increased nearly five times, while essential services remain unaffordable to many citizens. Education has burgeoned in cost during the same period and become less effective.

The growth in service sector employment has placed an extreme tax on the people and companies engaged in tangible production. Our problem is not that our people and companies do not know how to design and build good products. In the last quality survey, nine U.S. auto models beat Nissan in overall quality. American cars consistently do better than cars from any other country except Japan, and they are at least as good as most Japanese models. Our ability to compete globally is severely impacted by exceptionally high overhead cost.

High overhead costs are a social concern. These costs result in plant closings and job losses. There is simply no way that 25 million people engaged in tangible production can supply all of the food, manufactured goods, buildings, roads and raw materials for the 225 million people who are not engaged in production. The situation is not sustainable economically.

A closer analysis of America's cost of competing is revealing. Direct labor is not a big problem because U.S. wages are equal to or lower than major competitors. Emerging countries do have lower wages, but labor accounts for a small enough percentage of total product costs to keep direct labor from being a major obstacle to world-class competition. Labor quality is more of a problem. The U.S. education system
is vastly inferior to those in other industrial nations. It is not as thorough and it covers the wrong subjects.

Materials are no problem because the world market keeps U.S. costs at competitive levels.

Internal overhead is a great barrier to U.S. competitiveness and is likely to remain so. Even though the ranks of U.S. middle management are being reduced, government's propensity to shift societal costs to companies is keeping internal overhead costs high. Executive compensation also remains too high and impedes cooperation.

External overhead is the biggest problem of all, and it is not all public overhead. Services, finance, insurance, education and government all need to become much more cost-effective for the U.S. to continue as a viable nation. We cannot continue to siphon resources out of the productive units of our society and expect those units to remain competitive in world markets.
Prosperity: Prepare to encounter posterity

CITYBUSINESS -- March 27, 1998

As Ash Wednesday kicked off the beginning of Lent, we were marked with ashes with the admonishment, “Remember that you are dust, and to dust you shall return.” The phrase took on special meaning to some of us who may be closer to dust than others. In the midst of our immense prosperity, the clamorous stock market and rampant optimism in corporate America, any reminder of our mortality is a bit unsettling — but helpful. It’s good for us to consider that there may be a purpose more important than our own prosperity. The thought occurred to me that the administration of ashes wouldn’t be a bad practice for board meetings.

Some of us have questioned the magnitude and nature of the prosperity we are experiencing. What does it mean? What are our responsibilities? Do we simply get to live in these prosperous times and consume and enjoy the wealth? That would be nice, but it sounds too easy. There must be a catch.

Apart from any theological implications, which I will leave to those better prepared, I have a concern for how prosperity is affecting the way we do business. We invest and the market goes up. Often, we are richer not because we designed anything any better or built anything any better, or because we served our customers any better or even because we invested any better. At times, our wealth seems to be accumulating for no reason other than the fact that, through no fault of our own, we exist during good times. The key question is, has business become so easy that we have lost touch with the fundamentals? And, if our period of prosperity ends, will we know how to rebuild it?

There are, of course, some companies that have not lost these skills. Bermo is one of the best metal stampers in the country, and they are doing some solid investing. Their plants are models of state-of-the-art automation and good equipment. Clearly, it’s one of the best in the U.S. but, to put this expertise in perspective, there is one company in Singapore that is approximately six times Bermo’s size, also with very up-to-date equipment. There are other overseas competitors.

Remmele Engineering is also a world-class outfit, with what is perhaps the best complement of equipment in the Upper Midwest. For a long list of prestigious customers, Remmele can machine parts ranging in size from one millimeter in length to several tons in weight — all with the utmost precision. Remmele is another forward-looking Minnesota company that is not afraid to invest. So are Medtronic, Dynamic Engineering, HEI, Starkey, Custom Mold, Kurt, Horton and others.

But, not everyone is doing this investing. In this age of asset utilization, there is an unwholesome degree of caution about having too much invested in equipment or having a balance sheet that is insufficiently leveraged, or investing too much for long-term gains. There seems to be an emphasis on buying, rather than designing or making, and outsourcing seems to be the latest managerial fad. The dividend-payout ratio has increased from about 40 percent in the late ’60s and early ’70s to around 70 percent today. Since profit rates are lower now than they once were, the percentage of revenue being reinvested for the future is substantially smaller than it once was.

The irony comes when the capital investments of these major manufacturers are compared to other expenditures. The state bonding bill, hostile takeover attempts, huge amounts of “goodwill” placed on corporate balance sheets from overpriced mergers and acquisitions, the diversion of resources away from industry to financial institutions. We should wonder if Minnesota is preparing adequately for an industrial future. Some companies, are, of course, many of them private. But, over the years, we seem to have accumulated a lengthening list of companies preparing only for mediocrity. Market values are increasing because the market is up. Yet we are not adequately preparing for aggressive world competition.

The U.S. trade deficit recently reached a nine-year high. The problems of Southeast Asia will impact our companies. Southeast Asia is like Italy. The governments and the banks may be broke, but the modern production equipment and trained workers are still in place. Many of the Asian industrial companies remain vigorous competitors. The recent changes in exchange rates will allow them to more aggressively compete on price, and some U.S. companies are not positioned for this onslaught.
I am aware that everyone says the economy is great and the U.S. economic system is the envy of the world. Perhaps this is true, but time passes quickly. Our prosperity is still industrially based. Consider these facts:

- The 38,600 employees in Minnesota’s instrument industry earn a half a billion dollars a year more than the nearly 150,000 Minnesotans employed in the restaurant and bar industry.
- The 75,000 Minnesotans employed in the industrial machinery industry earn about half of what 450,000 people earned in retail trade.
- The 31,100 people employed in Minnesota’s paper industry earn 8 percent more than all of the 70,600 Minnesotans employed in car dealerships, auto repair and services, and 11 percent more than all of the 45,530 Minnesotans employed in all banks and nondepository financial institutions.
- The 10,840 people employed in Minnesota’s chemical industry earn almost as much as the 25,000 Minnesotans employed in real estate.

Clearly, with so much of our state’s real prosperity dependent upon tangible production, it is in our best interest to keep it strong for the future.

Robert Wolman, chief economist for BusinessWeek, recently made an interesting observation in a talk at the Humphrey Institute about his latest book, The Judas Economy. The return on capital is outstripping the return from work. When that happens for long periods, the capability to perform fundamental tasks first atrophies and then declines.

In this connection, and in others, the ashes make sense. We can’t be here just to consume. We have obligations to prepare for the future of those who come after us. This is happening with some elements of our society — but not enough.
Trade deficits endanger our future

CITYBUSINESS -- November 27, 1998

Recently it was announced that for the third time this year, the United States trade deficit again reached a new record high — $16.8 billion in a single month. The matter gets little attention in the news and virtually no attention at all in political campaigns. It is tragic that a development which can so compromise both the prosperity and social fabric of our entire nation gets so little attention. Yet its importance is not lost on the serious observers of our time — a few academics, some business people who travel internationally, students of central cities, representatives of industrial unions and people who participate actively in the industrial economy. If these trade deficits continue as they are, we must recognize that before long, we will no longer be a prominent nation, a military power, an economic giant or a haven for the world’s savings. Economic trends, fueled by geometric progressions, take place quickly. Such a dire prediction is ridiculous, you say. The U.S. is clearly the preeminent world economy — one of the few that is functioning reliably at the moment. We are fully justified in being concerned about Russia, Southeast Asia or Brazil, but not about the U.S. If anything, our economy has been overheated to the point that the biggest problem voiced by employers is the lack of availability of qualified people. Our statistical unemployment rate is exceedingly low while the stock market, though volatile, gets higher every year.

Beneath our apparent prosperity, however, are more worrisome events. Some of these merely indicate a return to more usual economic times, such as slipping consumer confidence, reduced profits, or gradually declining job formations. Others seem more fundamental — perhaps more endemic. Among these are declining rates of investment among U.S. industrial companies, exceptionally low savings rates, a shrinking base of suppliers of crucial industrial components, and the total exit of U.S. companies from strategic industries. There are bright signs such as the emergence of Nucor as one of the world’s preeminent steel companies and the strong competitive positions field by U.S. companies in aircraft and paper. But the list of where we excel is growing shorter. The U.S. counts for nothing in shipbuilding, an industry that spawns many other industries and much employment. We have slipped greatly in electrical equipment, computers and instruments. Our market penetration in machine tools is minuscule compared to what it was, even though Haas and a few others are turning out some good units. U.S. manufacturing is growing in nonstrategic areas such as office partitions, cookies, burial caskets and greeting cards. We welcome the employment, but these are not industries that foreshadow an industrial future.

From its peak in 1979, the U.S. has lost roughly three million manufacturing jobs. Improved methods and automation have perhaps reduced manufacturing employment but the empirical evidence is interesting. We are not currently losing much employment in the industries that are investing in better methods. We are losing employment in industries where investment is low. We have too many laid-back companies that lack the skills necessary to compete aggressively in world markets. Their task is no doubt made more difficult by an ever-burgeoning public sector — even during a period of supposed budget-balancing. During the same period that U.S. manufacturing employment declined by three million, government employment increased by four million. Higher taxes from a healthy economy are providing more revenue but government employment is continuing to grow — and with it, ever-expanding future retirement obligations.

The statistics are frightening. From 1988 to 1995, during a period of high prosperity, manufacturing employment declined by 31 percent in Baltimore, 33 percent in Brooklyn, 34 percent in Philadelphia and 27 percent in Union County, New Jersey. Most major metropolitan counties, including both Ramsey and Hennepin in Minnesota, are losing manufacturing jobs. Some of the lost jobs are made up by increasing employment in services, but there is a catch. Many services do not do well in recessions. Recently released corporate earnings point out that earnings were down 9 percent in manufacturing, but down 19 percent in services.

To the employees and the general community, the variance in economic yield between industrial segments is huge. Consider these facts:
* The 39,000 employees in Minnesota’s instrument industry earn a half a billion dollars a year more than the nearly 150,000 Minnesotans employed in the restaurant and bar industry.

* The 75,000 Minnesotans employed in the industrial-machinery industry earn about half of what 450,000 people earn in retail trade.

* The 31,000 people employed in Minnesota’s paper industry earn more than all of the 70,000 Minnesotans employed in car dealerships, auto repair and auto services, and more than the 45,000 Minnesotans employed in all banks and nondepository financial institutions.

* The 11,000 people employed in Minnesota’s chemical industry earn almost as much as the 24,000 Minnesotans employed in real estate.

Manufacturing is the one major industry where the percentage of Minnesota’s wages is much higher than the percentage of jobs. Nowhere is this variance in industries more noticeable than in voluntary fringe benefits, which vary from virtually nothing in some service industries to more than $10,000 per employee per year in some manufacturing industries.

The U.S. trade deficit can be greatly reduced, but attention is needed. In an effort to apply broad economic theories, public officials (both executive and congressional) have lost touch with the detail. The current administration has focused on the protection of movies and music — perhaps with an eye to the huge political contributions available from the entertainment industry. However, governmental initiatives have resulted in a flood of imports and diminished exports. Wages are not the driving factor in trade deficits. Much of our trade deficits in recent years actually occurred with higher-wage nations than the U.S. The U.S. runs trade deficits because we have not regarded the matter as important. We have failed to understand the connections between the industrial economy of today and prosperity in the future. The matter deserves attention.
Economy shares similarities with the side shows of old

Problem is not an emotional one, but rather a question of precisely how does it all add up.

MINNEAPOLIS STAR TRIBUNE -- December 7, 1998

It was pretty tranquil growing up in rural Minnesota in the 1950s and 1960s. Not much gambling. Not much speculation. People had an old-fashioned view of wealth accumulation - they earned it.

There were imperfections, of course, but on the whole most folks were content with a more gradual increase in their standard of living. It had been less than two decades since the Great Depression, so people were keenly aware that wealth accumulation is often bi-directional. Most folks were pretty conservative. It didn’t matter much if someone had more. The trick was to make sure one didn’t have less.

The most exotic form of risk and reward occurred at the county fair. Once a year people would flock there to show their animals or their crafts or to participate in 4H projects. These were harmless enough.

But then there was the midway - a place where we could witness real dishonesty in action. One fellow must have thrown 50 baseballs to win a “genuine” silver bracelet, which turned out to be aluminum. There were other examples.

The economy of the 1990s has peculiar similarities to the carnivals and side shows of 50 years ago.

The stock market is reaching new highs every week. Mergers and acquisitions are at sky-high prices. There is rampant consumer spending coincident with negative savings rates. Problematic financial and real-estate markets affect us from thousands of miles away. And U.S. trade deficits provide tangible evidence that every month our country buys $15 billion more than it sells.

The carnival is on - with all of the caveats P.T. Barnum had to offer.

How can an economy with so desperate a need to make investments remain competitive without saving anything? What does it mean when one bank pays $13.5 billion for $4 billion worth of net assets in another bank? If these big banks are so smart, why don’t they make as much money as small banks? Arithmetic problem.

To express concern about the workings of our economy is not to be a prophet of doom. Along with others, I applaud the effectiveness of the U.S. industrial sector and the opportunities we have before us. My problem is not emotional but arithmetic. I cannot figure out how our present economy computes.

There are some bright spots to be sure. It was a great pleasure to visit a plant of Nucor Steel, the most profitable steel company in the United States - though not the largest. Talk about productivity - the revenue per person at that plant was $1.3 million per year.

Ken Iverson, the company’s well-regarded chairman has conducted phone interviews with our Capstone Class at St. Thomas where he articulated some of the beliefs captured in his book, “Plain Talk.”

The people at Nucor make me feel better because they are investing, training people, improving quality and becoming more efficient every day. These things compute. I get similar feelings when visiting a host of other companies.

On the other hand, we have many industries where training, investment, leadership and innovation are not taking place - or at least not at the pace that can lead to survival. I also drove around a Bethlehem Steel plant that very much exuded a lack of training, a lack of investment and a lack of caring. It has since been closed. There are many plants like this, too.

The recently announced merger of America OnLine and Netscape Communications provides a vivid example of the kewpie doll economy.
These two companies now have a combined market capitalization of $42.1 billion, about the same as General Motors with its $165 billion in revenue, $2.6 billion in earnings, its vast investment and its 693,000 employees. The AOL/Netscape combination has revenues of $3.1 billion, 10,885 employees and a combined loss of $23 million. Even these financial results may be suspect. The Securities and Exchange Commission has intervened twice in the past few years regarding AOL’s accounting treatments.

Gambling exploits.

A few years ago I was puzzled about the bankruptcy of Olympia & York when it was revealed that some of the world’s larger banks had combined to loan one family $26 billion - but the family didn’t handle the money well. Not dissimilar, I suppose, from the multi-billions loaned to an ex-Salomon executive whose bizarre gambling exploits were featured in the book, “Liars Poker.”.

The resulting $3.6 billion bailout of his aggressively named firm, Long Term Capital Management, required the involvement of the Federal Reserve Bank of New York and will cost U.S. investors for decades to come.

Now the most hallowed of all Western European banks, Deutsche Bank, has decided to acquire Bankers Trust, that warm-hearted professional firm that has recently been investigated for racketeering, gave us derivatives and provided money for the leveraged buyout of Northwest Airlines.

AT&T lost billions of its shareholders’ equity on poorly thought-out unstrategic acquisitions and then spun off its premier research institution, Bell Labs.

Avon branched out from perfume to health care with smelly results.

The lost focus at Bausch & Lomb resulted in a flurry of lawsuits and serious charges from regulatory authorities because of improper accounting.

After a series of disastrous strategic decisions, the lights went out at Westinghouse and the company that was at one time larger than General Electric is no longer a player in electrical equipment.

Lastly, 75 years after being broken up as part of the Standard Oil Trust, Exxon and Mobil plan to merge.

Things are not yet delightful in the developing world, either. Within the past years, the liquidity ratio of the International Monetary Fund (IMF) has fallen to 19 percent with still more money needed for Brazil, Russia and many other places.

We should have the compassion to help distressed people in developing countries, but there is some evidence that this munificence does not always get to the people intended. In spite of some occasional good work and laudable objectives, the IMF operations often act to bail out foolish bankers and crooked politicians simultaneously.

For its part, the Clinton administration seems content to posture the United States as the importer of last resort, at great cost to the nation’s manufacturers and industrial workers.

It is true that we can be thankful for the prosperity that exists at the moment. But, at a time when it is imperative to preserve a strongly competitive economy, we seem to be neglecting some of the basics - such as saving, investment, prudent stewardship, responsible leadership and plain, old-fashioned honesty.

Maybe there is science to our present speculative mode. Maybe there is sound financial management on the part of the people we have trusted with the nation’s savings. But, it does seem a bit like a side show.

I just hope that there is at least an aluminum bracelet in there someplace.
Whose productivity?

Rising U.S. productivity raises some questions about what gets measured, what doesn’t and how our foreign rivals are performing

MINNEAPOLIS STAR TRIBUNE -- February 21, 2000

Along with others, I was pleased to learn that productivity had grown by 4.8 percent during the fourth quarter of 1999. Even more impressive was the 10.7 percent productivity gain in manufacturing, which has long been the provider of much of the nation’s wealth. Productivity is a key ingredient to prosperity, and the stock market responded favorably - but then slipped.

The reported results are impressive, but should be kept in perspective.

Measurements and estimates of U.S. productivity have been made and published almost continuously since the Hand and Machine Labor Report in 1898. No statistics are flawless and productivity statistics are no exception. The task is made especially difficult in part due to the intricacy of measuring certain transactions and the awesome task of persuading a huge number of employers, agencies and industries to fill out lengthy reports.

But competent people and cooperative people are in charge of these efforts. John Duke and his associates at the Bureau of Labor Statistics (BLS) are both practical and eager to help.

Productivity coverage throughout the economy is by no means uniform. With the latest expansion of the BLS Industry Productivity Database, productivity estimates are now reported on industries covering about 54 percent of U.S. employment, but the degree of coverage varies greatly by sector.

- Mining and manufacturing are nearly fully covered (96 percent and 100 percent) but are not expanding.
- Services, which is expanding, is about 16 percent covered.
- Finance, insurance and real estate is about 19 percent covered and wholesale trade about 2 percent.
- Medical services, so important to our welfare and our economy, are not covered at all.

So what do we really know about the productivity of so many of us?

One of our faculty members at the University of St. Thomas, George Gleeson, suggests that the last productivity improvement in education was dustless chalk.

We have not really figured out meaningful ways to measure whether or not most of us are becoming more productive. There may indeed be improvement - but we may not be able to find evidence in the federal statistics.

Perhaps the most valuable measure in the productivity statistics is unit labor costs - a key determinant of our long-term competitive position.

Comparing the fourth quarter of 1999 to the third quarter, productivity grew more rapidly than compensation (4.8 percent versus 3.6 percent), so unit labor costs decreased 1.2 percent.

That impressed everyone. But the year-to-year comparison was not quite so glamorous. Comparing the fourth quarters of 1998 and 1999, output per hour grew by 3.3 percent, compensation by 4.5 percent. So unit labor costs rose by 1.2 percent. A little less impressive.

We have competitors.

If unit labor costs continue to increase versus those of our competitors, we will find it more difficult to prosper. And we are not alone in making productivity improvements. Our international competitors are getting more productive as well and often in much greater increments. From 1995 to 1998, the unit labor cost of a trade-weighted mix of international competitors declined by 19 percent vis-a-vis the United States.
Looking at the problem another way, because of exchange rate changes and economic conditions in local countries, average manufacturing wages (in U.S. dollars) increased 8 percent in the United States while they declined 12 percent in Germany, 24 percent in Japan, and 32 percent in South Korea.

Given the fact that there are roughly six times as many science and engineering graduates being turned out in Southeast Asia as in the United States, we should not assume that we have a God-given entitlement to productivity and prosperity improvements.

The fact is that many of the world’s most respected technical advancements now take place outside of the United States.

Month after month of record-setting trade deficits is, of course, the best testimonial to the emerging technical prowess of our competitors during a time when their unit labor costs are decreasing.

Another important caveat should be observed when considering productivity statistics. They deal only with the working population. During a time when our working population is showing increased productivity, we can observe disturbing trends in the ratio of retirees to workers — soon to reach a ratio of about 2 to 1. Last week, it was announced that the Minnesota Public Employee Retirement Association is running short of funds.

Surprise! For years, Minnesota has had generous programs for early retirements for public employees during a time when we are all living longer.

At the same time, we have many more people in public occupations. During the 1950s, the United States had about 2.5 times as many people working in manufacturing as in the government. Now we have 1.5 million more people working in the government than in manufacturing. As productive as our industry has become, it will probably not generate the cash sufficient to fund future cost-of-living-adjusted, defined-benefit obligations for people who will live 40 years after they quit work.

**Gaining by subtraction?**

With another perspective, Professors Cohen and Zysmann of the University of California have argued that we have achieved productivity improvements largely through subtraction — that is, we have closed marginal businesses. While we are showing statistical progress, we are experiencing widespread corporate restructurings, which may not have been fully appraised.

A related caution also is in order. If we do more outsourcing, particularly overseas outsourcing, we will have the same gross output with fewer labor hours and our statistical output per labor hour will appear to increase.

This anomaly is partially addressed with multifactor productivity statistics, but these are not yet widespread. It is quite possible that much of the observed productivity improvements are due to the rapid expansion of outsourcing through the industrial economy.

We are living in very good times and we should be quite thankful. We are making some genuine improvements. But, the United States needs to look realistically at our current economic situation.

- Yes, a lot is being sold - but much of it on credit.
- Yes, the stock market has been high - but more than 60 percent of stocks are lower than they were last summer. And during 1999, margin debt increased from $140 billion to $230 billion.
- Unprofitable companies amounting to little more than hubs on the Internet have been bid up to market valuation multiples in excess of some of our most dependable, technology- and asset-rich corporations.
- We have come to believe that bolting together a few hundred dollars worth of Chinese computer parts and calling it a PC is “technology” when many of our graduating high school seniors couldn’t fix a misaligned cover on their CD player.

So, yes, productivity is up - but so is everybody else’s. In addition, we have already promised some of the expected receipts. If we do not make some substantive improvements in education, allocation of resources, and our country’s industrial strength, on-going productivity improvements - and the prosperity that comes with them - might be harder to obtain.
What were we thinking?

As investors grapple with their misfortunes and the post-bubble finger-pointing on Wall Street continues, it’s worth asking how much we ourselves are to blame.

MINNEAPOLIS STAR TRIBUNE -- June 29, 2002

It was common until about 1952 for most frugal people to drive pre-World War II cars. Mike Curry was no exception.

Mike was a retired law enforcement official, a highly successful investor and a very kindly neighbor. One day, somebody ran into his ‘37 Ford and caved in the left door, but he continued to drive it.

Months later, when asked when he was going to get his car fixed, Mike quietly replied, “As long as it still has a right door, it is just as good for me as it ever was.”.

Mike thereby exhibited a quality that has come to be rare in recent times: the graceful acceptance of misfortune.

During this time of declining stock values, misbehavior at companies and chicanery on Wall Street, it is always comforting to have someone to blame. It couldn’t be us, after all. Our losses should be covered - by someone. Let’s find someone to cover us.

The 1990s produced market expansion, speculation, fraudulent behavior, ineffective oversight and, from early 2000 until now, dramatic market reversals. Accounting firms were weak and too compliant.

The nation’s securities laws were poorly enforced by both the Securities and Exchange Commission (SEC) and Department of Justice. The quality of investment analysis was low.

The scandals of the past several months are indeed troubling and should not be condoned. But they are not a surprise.

Every semester, I have the great privilege of reading about 100 term papers. Many of my students examine the strategies, tactics and competitiveness of individual companies and then compare them with other foreign and domestic companies operating in the same field. They examine operating ratios and balance-sheet integrity, as well as the company’s customs and managerial practices.

Over the years, our students have correctly predicted the demise of Midwest Federal, K-Mart, Montgomery Ward, Control Data, WorldCom, LTV, Daewoo, Sun Country and Qwest, among others.

They have correctly analyzed weaknesses at Enron, AT&T, Cisco, and, at an early stage, General Electric.

If the students can figure it out, why couldn’t the fund managers, securities analysts and the SEC staff during the go-go years of 1993 to 2000?.

Behind the bogus numbers.

Accounting laxity and the failures in corporate governance have been well-documented in today’s press. What has been less well-covered are the weaknesses in enforcement and the general naivety of many investment bankers and investors.

In his 2000 book, “Irrational Exuberance,” Yale professor Robert Shiller warned that the mass overpricing in speculative common stocks was far outstripping the economic fundamentals of that era. In 1996, Federal Reserve Chairman Alan Greenspan delivered a similar message to Congress, using the phrase that served as the title of Shiller’s book. David Dreman and Warren Buffett have been preaching the virtue of sensible value investing for years.

A careful reading of the financial statements and filings of the now-defamed offending companies yielded plenty of warnings early on.
AOL had been challenged on revenue recognition as its market value was exceeding that of General Motors. New and peculiar accounting terms were employed to display progress in companies where no serious business model existed.

The financial statements of Honeywell’s future acquirer, AlliedSignal, were not impressive, either, since it was burdened with huge debt, low margins, a weak balance sheet, slow-moving inventory, and peculiar looking financial statements well before its merger with Honeywell. There were many other examples.

Why would we ever have expected any investments in these companies to work out? The frenetic acquisition of companies went beyond the ability of management to make the acquisitions successful.

The predictable result? Demoralized employees; money stripped from research, product development and operations to pay for acquisitions at highly inflated prices, and offensive executive compensation. Why would we expect success?

The Wall Street Journal recently reported that U.S. merger and acquisition activity reached 15 to 16 percent of the Gross Domestic Product from 1998 through 2000 but has fallen to 2 percent today. Among the big acquirers were:

- WorldCom: more than 70 acquisitions.
- AT&T recently sold cable companies it acquired in the 1990s to Comcast at a loss exceeding $35 billion.
- Cisco: 70 acquisitions.
- First Union: 90 bank acquisitions.

Many of these acquisitions have common attributes - heavy debt, low investment in products and manufacturing, out-of-touch management and the crass treatment of employees.

Solid companies exist.

Yet, all along the way, there have been many fine companies. These are the companies that stick to their knitting, spurn activities for which they have no expertise, operate frugally, employ reasonable executive compensation, and foster a sense of prudence and responsibility in their operations.

We have some big company examples such as Nucor Steel, Deere, Medtronic and others. And we have some well-run smaller companies, as well - companies that treat their employees, creditors, shareholders and their communities with respect.

The Old Log Theater in Excelsior has one of the longest records of profitability of any theater in the United States. One evening, I called to get tickets. A friendly voice promptly answered the phone and gracefully took my order. Since the voice was familiar, I then asked who it was.

“This is Tom Stolz,” came the reply. Tom is one of the lead actors and I asked, “Aren’t you in the play?” He replied, “Yeah, but I’m between scenes.”

Now, if WorldCom, Qwest and Global Crossing would have operated as frugally, understood their business as well, and treated their customers with similar respect, maybe they would not be in quite so much trouble.

Is there something to be gained by suing everyone regarding our declining portfolio values? Certainly there were excesses that should be punished severely. I would like to see some offenders and lackadaisical enforcement officials not only go to jail, I would like to see them all in the same cell.

From what I understand, they all have obnoxious personalities, and perhaps prolonged imprisonment with Gary Winnick or Bernie Ebbers would serve as a powerful deterrent.

But, maybe part of the problem was our own behavior. Shouldn’t we have known better?

Mike Curry might have driven around with a big dent in his ‘37 Ford. But I cannot imagine him buying WorldCom stock.
Quality and economic self-interest

Today’s U.S.-made cars are more reliable and often cheaper than the imports. And by buying American, we help preserve our country’s sagging industrial base.

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My father harbored a mild distrust of large businesses, so we often had off-brand cars: Hudsons, Nashes, Kaisers, Packards and one Studebaker - which was enough.

At an early age, I took an interest in the technology of these cars and compared them with the Chevrolets, Fords and Chryslers in our area of rural Minnesota.

In some ways, the off-brand cars were quite advanced. The Nash, in particular, had many safety, convenience and economy features and generally superior machining tolerances. Hudsons were fast cars with good handling. Packards were very quiet, luxurious, with good drive-train design.

It saddened me to watch these manufacturers disappear from the American landscape. The Kaiser was last produced in 1955, Hudson in 1957 and, alas, the once glorious Packard left the stage in 1958. Studebaker, then 114 years old, ceased production in 1966. Nash continued under the name American Motors until its acquisition by Chrysler in 1987.

Each of these companies, though smaller than the Big Three, was a significant part of the U.S. economy. Both Willys-Overland and Hudson directly employed 21,000 people at their peak, with many more jobs created in supplier and dealer organizations. Kaiser employed 20,000 and American Motors 33,000. Remnants linger here and there but this once-vibrant sector of our nation’s history is largely gone - replaced by a flood of imports.

New Big Three.

Today, there is a new Big Three. Toyota recently surpassed Chrysler in U.S. auto sales. The decline of Chrysler, at one time the nation’s second-largest auto producer, had been brewing since the 1998 takeover by Germany’s Daimler-Benz, an event chronicled in the 2001 book “Taken for A Ride: How Daimler-Benz Drove Off With Chrysler,” by Bill Vlasic and Bradley A. Stertz.

Though Chrysler made it into the corporate name, a colleague of mine well-steeped in German business circles once asked if I knew how to pronounce Chrysler in German. He went on, “You don’t. In German, Chrysler is silent.”

We can keep giving away our industry, I suppose. Other countries have done it. But its depletion will affect a lot more people than those directly employed in these industries. Corporations are citizens. They provide jobs and fringe benefits. More importantly, they provide personal dignity and a sense of accomplishment for which there is little substitute when industry declines.

Industrial corporations give rise to much of the service economy. However, the empirical evidence shows, there isn’t much of a service economy in the face of declining industry.

Chrysler could have prevailed as a separate company. This segment of Daimler Chrysler still gets most of its sales from vehicles developed during the pre-merger era; the PT Cruiser, the minivan, the Dodge Ram pickup, the Chrysler 300. Recent Daimler-initiated vehicles, such as the Pacifica, have sold poorly.

U.S. manufacturers are putting forth excellent products during this intensely competitive era in automotive history. The recently released J.D. Power survey of vehicle dependability placed four U.S. makes in the top 10: Buick, Cadillac, Lincoln and Mercury.

Several of the others, including Honda and Toyota, are mostly manufactured in U.S. plants. The bottom of the list includes three Korean makes, three Japanese, three European and another product from Daimler Chrysler. Ironically, Dodge, Plymouth and Chrysler all scored higher in the J.D. Power quality survey than Mercedes-Benz, which was 11th from the bottom.
U.S. manufacturers can hold their heads high on productivity, too. Two of the top 10 plants in labor productivity are General Motors plants and two are Ford plants. Ford and GM are both delivering quality products at reasonable costs, and contributing to the welfare of their country by doing it. Compare the quality. Compare the values. And, especially, compare the price of parts. U.S. products in this industry are very good.

**Legacy costs.**

U.S. producers have obstacles to overcome, of course. Chief among them are legacy costs: retirement and health care benefits accumulated over the 100 years Ford and GM have been in existence. The bills are large, amounting to several billion per year for both companies. General Motors’ cost for retirement and health benefits adds up to $1,360 per vehicle, far higher than for many foreign producers.

Still, U.S. automakers have not done as steel companies Bethlehem and LTV did: file bankruptcy and let the reduced pension obligations be taken over by the federal Pension Benefit Guarantee Corp.

The auto workers are doing their part. The United Auto Workers recently reached agreements with Ford, GM, Chrysler and parts suppliers Delphi and Visteon that will provide some maneuvering room on other costs as the benefits are maintained. There is teamwork in this industry.

I am proud of the U.S. auto companies. They have competed effectively. Their vehicles are good to excellent. Importantly, they have kept their commitments during a time when that character trait is not universal. But there is another dimension to U.S. auto producers: Many of the people who work there care deeply about the country.

Lew Veraldi, former senior vice president of new car programs at Ford, was a friend of mine and helpful to us at the University of St. Thomas.

As the leader of Ford’s successful Taurus/Sable project and many other programs, he was elected Auto Industry Executive of the year in 1987. Three years later, I attended his funeral at a modest Catholic church near Detroit.

Lew cared deeply about his country and the constructive role that Ford could play in maintaining the nation’s prosperity. The Taurus/Sable project, delivered at record speed and under budget, launched a whole new way to develop products, which we now call simultaneous engineering.

I can distinctly remember one of Lew’s comments in one of our last discussions: “Fred, tell these students not to worry about how much money they make. Have them do something that is good for the country.”

The U.S. auto industry has produced many other idealists who have advanced the way we live our lives; Charles Nash, Walter Chrysler, Douglas Fraser, Charlie Wilson and many others. During World War II, this industry provided 92 percent of the personnel carriers, 75 percent of the aircraft engines, 56 percent of the carbines and a variety of other products needed for the conflict - including 10 percent of the aircraft. During peacetime, the auto industry has provided prosperity to communities across the land.

So what are we supposed to do? Buy a bunch of overpriced foreign cars with little regard to the impact on the prosperity of the nation? Let the nation’s $50-billion-per-month trade deficit continue forever? Let our cities see if they can exist without industry?

We don’t have to make hard choices. Several U.S. makes rank higher on the latest quality surveys than BMW, Mercedes, Nissan, Audi, Volkswagen and Mitsubishi and they are, for the most part, less costly. Having strong industry is clearly in the nation’s best interest, and the best interest of car owners as well.
NWA woes will ripple through MN economy

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The bankruptcy of Northwest Airlines will likely have a substantial and prolonged impact on almost all the industries in Minnesota.

Lending institutions will have a few more problem loans. Housing prices will ease in some areas. Income-tax receipts will be reduced, thus exacerbating Minnesota’s budget difficulties. Business expansion may slow, tarnishing the perceived prominence of the Minneapolis/St. Paul marketplace.

Yes, Minnesota’s economy is certainly large enough to survive, but it is unlikely to survive without impact. After all, 15 years ago Northwest had the largest private payroll in the state, and it remains one of the largest.

Northwest’s bankruptcy has to be seen as a sad event that has been anticipated for years. Doug Carroll, a reporter for Money, wrote in 1992:

“Before the airline’s $3.65 billion leveraged buyout in mid-1989, Northwest had one of the industry’s strongest balance sheets and most fiscally conservative managements. Today, Northwest is reeling from three years of heavy losses and a still-staggering debt load left from the buyout. And nobody laughs when you say Northwest and Chapter 11 in the same sentence.”

For the quarter ended June 30 of 2005, Northwest reported tangible assets of $12.3 billion, but liabilities of $17.9 billion — a tangible net worth deficit of $5.3 billion. Add to that the airline’s underfunded pension liability of $5.7 billion and recent operating losses. Northwest is likely now in the hole by about $12 billion — a disastrous situation by itself but particularly horrific when compared to the strong financial condition of earlier years.

Taxes and lawyers have the most privileged positions for payment during bankruptcy. Taxes must be paid and the proceedings are likely to be lengthy, so fees will be high. Northwest’s secured creditors are owed nearly the full value of the airline’s tangible assets. It is hard to see how there will be much money left over to pay the $5 billion owed to unsecured creditors, so some bank debt may have to be compromised. Credit cards and other loans issued to former employees may not be paid in the usual manner. Many people needing to find other jobs may influence local housing markets.

The role of the Twin Cities as a regional center may be trimmed with this bankruptcy if patterns experienced in other airline bankruptcies are repeated. In the cases of the Braniff, Eastern, US Airways, and United bankruptcies, competing airlines took over larger shares of markets. Since no other major airlines are hubbed here, Northwest’s weakened position may result in an overall reduction in the prosperity generated by the MSP airport. In addition, the Metropolitan Airports Commission is owed $275 million dollars as a result of Minnesota’s poorly administered bailout of Northwest in 1992.

Northwest’s bankruptcy will be felt nationally as well. The federally sponsored Pension Benefit Guaranty Corporation (PBGC) is already straining from the recent bankruptcies of Bethlehem Steel, LTV and others.

It is essentially an insurance fund without premiums. If the PBGC has to now pick up the liabilities of unfunded airlines pensions, a new infusion of cash from the federal government will be necessary at a time when Katrina, Iraq and a weakened economy are already placing strains on the credibility of the nation’s currency.

Notwithstanding the enormous costs to be paid by citizens of our state and nation, the perpetrators of the 1989 buyout did not do badly for themselves. According to the public records, Al Checchi sold $29 million worth of NWAC stock, Fred Malek sold $1 million, and Gary Wilson sold $34 million in the past two years. What they sold previously is not readily available. The bankruptcy of Northwest is a tragic event that hopefully will be fully investigated by the state of Minnesota, the Department of Justice, the Security and Exchange Commission and other appropriate agencies. But, it is not an unexpected event. Bankruptcy was both predicted and probable following the amateurish and unfortunate leveraged buyout of 1989.