*In a correction or a bear market, great companies, good companies, mediocre companies, and terrible companies all see the prices of their stocks decline. A correction is a wonderful opportunity to buy your favorite companies at a bargain price.

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In Defense of the Invisible Hand

Difficult as layoffs are, they happen for good reasons -- and produce results we wouldn't want to live without

By Peter Lynch

Has the invisible hand ever been so invisible as it is in our country today? I'm referring, of course, to Adam Smith's notion that the market forces of capitalism will produce the best results -- economically and socially -- if they are simply left alone. These days, everyone seems to have forgotten Adam Smith. The press is fixated on layoffs and business avarice.

"Call it 'in-your-face capitalism,'" Newsweek barked. "You lose your job, your ex-employer's stock price rises, the CEO gets a fat raise." The sentiment was echoed by Business Week. And TheNew York Times logged in with a seven-part series that focused on two groups of people: those who had gotten the ax and those who still had jobs but were worried the ax would fall on them next. The employed and the unemployed alike were depicted as victims of corporate greed. CG has become such a hot campaign issue that even the Republicans have been denouncing it.

It goes without saying (although I'll say it anyway) that there's nothing happy about somebody losing a job, especially if that somebody has no immediate prospects for finding another one. Only an ice sculpture would not feel compassion for the thousands of workers getting pink slips from AT&T;, or the three million who were let go by the 499 other Fortune 500 companies in the 1980s, or the next three million who will be idled by the end of the 1990s. That these widespread layoffs have created widespread financial and emotional hardship is beyond doubt. What I doubt is the conclusion that some people appear to be drawing from all this -- namely, that capitalism is evil and exists to spread misery by separating people from their livelihoods.

Job insecurity has been a problem for as long as people have depended on a paycheck. In the last century, half the U.S. population lived and worked on farms, so we've already lost two-thirds of the farming jobs. At one time, there were more than 200 manufacturers in the auto industry; at another point, the steel industry employed one of every 100 workers. Today, we have a handful of auto companies and two-thirds of the steel jobs have disappeared, but somehow the country has managed to survive and prosper.

Many companies can and should do more to help the recipients of pink slips get the training and referrals they need to catch on someplace else. But the pessimism aroused by layoffs per se simply isn't justified. We got a similar dose of pessimism in the late 1940s and into the 1950s, after the war was over and 10 million to 20 million Americans lost their war-related jobs in the defense industries. More than a third of the workforce had to find employment elsewhere. Life looked bleak for millions of workers.

Today, there's also an ominous sense that the recent pace of layoffs in the big-name companies will continue. More likely, we are closer to the end of the dismissals at places like AT&T.; These companies can't run on zero employees. Moreover, most of the reductions are not as heartless as they look, because they are accomplished through normal attrition: People retire, they change careers, they move elsewhere.

Again and again, new opportunities have arisen to take the place of the lost opportunities. This is the way the capitalist ecology works. Industries decline, old companies wither away, and young companies rise up to replace them. This process is hard on many, but ultimately, it is healthy.

The strength of our economy is that it is dynamic and always adapting to changing conditions. That's our advantage in the world. That's the reason we're as creative as we are as a nation. We're number one in music, television, and movies. We're the low-cost producers in forest products, paper, aluminum, and chemicals. We're tops in software, robotics, cellular phones, pharmaceuticals, electronics, telecommunications, and farm equipment. We excel at genetic engineering, microprocessing, and networking.

Helped partly by a falling dollar and also by a revived domestic business climate, our share of the export market is rising. We ship steel to Seoul, transistors to Tokyo, cars to Cologne, spandex to Siena, and bike parts to Bombay. Seven hundred million men and women worldwide shave with Gillette. The skies are filled with Boeing aircraft. Japan may have been the master of memory chips, TVs, and fax machines, but the Japanese can't keep up with the brainstorms coming out of U.S. companies like Intel, Texas Instruments, Cisco Systems, Sun Microsystems, Novell, Bay Networks, and Microsoft. We dominate every phase of computing, from software and hardware to printers and workstations.

The improvements in productivity achieved by business in this country have benefited nearly everyone in some way. Consider what's happened to the telephone industry. In 1983, AT&T; was a monopoly with a million employees. Today, among Ma Bell and the seven Baby Bells, there are 750,000 employees. These 750,000 are handling twice as many calls as their counterparts did in 1984 -- plus all the data, fax, and cellular exchanges that didn't exist in 1983. People are paying less for phone calls and getting more for their money.

It's amazing that the basic cause of the downsizing is so rarely acknowledged: These companies have more workers than they really need -- or can afford to pay. CEOs aren't callous Scrooges shouting "Bah humbug" as they shove loyal workers out the door; they are responding to a competitive situation that demands they become more productive. Would we be leading the world in so many industries if capital and labor were trapped together in outmoded, inefficient businesses with millions of workers holding down unnecessary jobs only for the paycheck? That was the situation that helped cause the collapse of the Soviet Union.

In spite of the continual process of certain industries' shedding their excess workers, America has been expanding the workforce at a record rate. According to the Bureau of Labor Statistics, we've added 54 million jobs in this country since 1965, so nearly half the jobs that exist today didn't exist 30 years ago. The nations of the European Union, with nearly a third more people than the U.S., have added a fifth as many jobs over that same period.

That means we're about 40 million jobs ahead of the Europeans, who for the longest time were held up as a model of efficiency and humanity in labor. Yet they've got 11 percent unemployment to our 5.6 percent, and nearly 20 million Europeans are now out of work. The United Kingdom's job rolls have barely grown (and by some accounts they've actually shrunk) since the Beatles cut their first album. What do these numbers tell us about the comparative strength of our economy versus theirs?

There's no doubt some people have been forced into lower-paying jobs, and one group is clearly worse off than it was in 1965: the people whose education stops at high school or below. That's because steel companies and other heavy industries are no longer hiring high-paid unskilled labor. Much of the assembly-line work has been automated.

But the myth that corporate chieftains squeeze labor to fatten their own paychecks is just that: a myth. When health-care and other benefits are added to the equation, U.S. workers are paid a bigger share of corporate revenues than they were in the 1950s and the 1960s, which are regarded nostalgically as the heyday of American labor. Meanwhile, corporate profits are actually lower now than they were then by a large margin: 10 percent of revenue in the 1950s; 5 percent today.

From time to time, you'll find a corporate type who tries to profit at the expense of the business; we saw that in some of the leveraged buyouts of the 1980s. But as a rule, the self-interest of the CEO and the interest of the company are identical. The executives, the shareholders, and the people on the assembly line are basically in the same boat. Ask yourself this: Where is it more rewarding to work, at a struggling Kmart or a thriving Microsoft?

If we must blame somebody for the layoffs, it ought to be you and me. All of us are looking for the best deals in clothing, computers, and telephone service -- and rewarding the high-quality, low-cost providers with our business. I haven't met one person who would agree to pay AT&T; twice the going rate for phone service if AT&T; would promise to stop laying people off. These companies are responding to the constant pressure from consumers and shareholders.

By the way, the competitive pressures that companies face don't necessarily come from abroad. AT&T; isn't worried about losing customers to Telfonos de Mexico or Philippine Long Distance. It's worried about losing customers to MCI, the cable systems, the Baby Bells, and a slew of small companies (called resellers) that offer discount phone service.

Let's look at the market forces in action. Older companies in established industries are struggling to keep up with the times. Younger, more aggressive companies are challenging the older companies or starting new industries from scratch. The jobs lost when the older companies falter are made up and then some in the younger companies that succeed.

Business today is criticized for being heartless and greedy, but it was lambasted for being soft, lazy, and out of touch with reality not long ago. In the mid-1980s, we learned that the Japanese made better products than we did, and that the Germans worked harder than we did, and that while our corporate leaders were thinking about their golf scores and getting a good table at Lutce their corporate leaders were plotting how to outsell and outproduce us.

Detroit was the target of much of the criticism, and it deserved what it got. The Big Three auto companies made second-rate cars in run-down factories as the unions pressured them to pay higher and higher wages, which were tacked onto the price of the cars. So consumers got less car for more money, until the Japanese and the Germans arrived and offered more car for less money. Millions of once loyal domestic car buyers defected to foreign brands, and the auto industry became a symbol of the decline and fall of U.S. industry in general. From 1979 to 1982, Chrysler was in a more or less constant state of crisis, with bankruptcy a serious threat. Chrysler was saved by strong leadership, layoffs, cost cutting, and an impressive lineup of new products (the minivan, the K-car, the revamped Jeep, etc.). It did get $1.5 billion in federally guaranteed loans in 1980 (which made it possible for the company to actually produce the cars that would save it), but it paid off every dime. The strong leader was Lee Iacocca, and the turnaround he orchestrated was so successful that he deserved every penny of whatever Chrysler paid him.

Without Iacocca, it's quite likely that Chrysler would be as extinct as Studebaker or Nash. But it is alive and solvent enough to support perhaps 500,000 workers, if you count its 126,000 employees plus those of its suppliers. That's a huge number when you consider there are only 18 million manufacturing jobs left in the U.S. Last year, Chrysler employees got an average of $3,200 in profit-sharing bonuses.

Other manufacturing companies followed Chrysler's lead in downsizing, cutting costs, and developing new products. Few were in as desperate a fix as Chrysler, but they had all struggled through the recession of 1982. They decided to make big changes that would free them from the old routine of adding workers in good times and laying them off in bad.

The urge to become more productive with a smaller workforce spread from manufacturing into retailing, pharmaceuticals, banks, financial services, and, most recently, newspapers and entertainment. Even when companies posted record earnings, they put themselves through the Chrysler drill (cut costs, make better products) to prepare for tougher times ahead. They wanted to avoid the fate of some very large companies that had failed to prepare and were lost in Chapter 11.

As a result of this efficiency campaign, the U.S. labor force has become the most productive in the world. According to the most recent numbers from the Bureau of Labor Statistics, the average American worker produces $49,600 worth of goods per year, $5,500 more than the average German and almost $12,000 more than the average Japanese. This extra productivity gives a company a lot of options.

Let's say it builds a new plant, where the same work crew from the old plant can increase the output by 15 percent. It can use that 15 percent to give employees a 5 percent raise, making the workers happy; to lower prices by 5 percent, making customers happy; and to still increase profits, making the shareholders happy. Of course, the productivity windfall could be divided up in different ways, but the point is that there are multiple benefits to becoming more competitive.

If you ask me, we have two key factors to thank for whatever prosperity we have enjoyed as a nation in recent years: Enough large companies have continued to do well, la Chrysler, while small companies have blossomed. Without one or the other, we'd be in a sorry state.

A list of 25 large companies that have managed to stay in top shape appears on page 90. Many names could have been included, but these are some of the standouts. A few have overcome serious trouble. Others are in the process of turning themselves around. Others have kept up their earnings growth against the odds. Others have accelerated their growth rates, which is a rare feat for a giant enterprise such as Coca-Cola.

Hewlett-Packard is one of the companies that hit the accelerator. In 1975, it was a manufacturer of testing and measuring equipment, one-fifteenth the size of IBM, with annual sales of $981 million. In 1995, its sales were $31.5 billion, only 10 percent of which came from the testing and measuring divisions. The vast majority of sales ($25.3 billion) came from printers and computers. Hewlett-Packard is now half the size of IBM, a leader in printers, and ranked sixth in computer sales worldwide, even though as late as 1983 it had never made a printer. It was reinvigorated by employees who were encouraged to dream up new products.

Lumped together, the 25 companies on the list have doubled their sales and profits in the recent decade. They've also cut 363,000 jobs, making them likely targets for negative publicity about the downsizing disease, but I cringe when I try to imagine the troubles we'd have if they hadn't downsized and created better products. A few big bankruptcies in the Fortune 500 are all it would take to stretch the unemployment lines around several blocks. Instead of 3 million jobs lost in the 500 largest companies, we might have lost 10 million or 15 million.

While the innovative large companies have been holding up their end, the small companies have been blossoming remarkably. No one has an exact count on how many jobs they've generated, but we do know that 6.3 million new businesses opened their doors in the U.S. in the 1980s alone.

Among these 6.3 million new businesses is an elite group of high achievers. Twenty-five of the most successful are listed on page 92. All but one (Cabot) went public in the past two decades. Had we packed the list with the all-stars of the computer industry, the performance of the group would have looked even better. But we chose a representative sample from different industries to show that companies of all kinds can grow up very fast in America. We included a toy company, a payroll processor, an airline, even a company that makes the carbon black used to strengthen tires. That's Cabot, which went through a difficult period but turned itself around.

In 1985, these 25 small companies had sales of $31.4 billion combined, less than half the sales of Exxon alone. Their combined earnings were one-quarter of IBM's earnings. They employed 368,000 workers, while the 25 firms in our large-company category employed 2.6 million workers.

By March 1996, the small companies had sales of $260 billion and employed more than 1.4 million workers. So while our 25 large companies were cutting 363,000 jobs, the smaller group was adding more than a million.

Wal-Mart was small enough to make the small-company list in 1985, but today it is bigger than every company on the large list except Exxon. Toys 'R' Us was a medium-sized company in 1985, but now it has more sales than Gillette or Colgate and 22,000 more employees than Goodyear. Amgen didn't exist in 1975, and in 1985 it employed 200 people. Today, it makes a pair of $200 million pharmaceuticals, Neupogen and Epogen, which helped Amgen earn more than $538 million in 1995.

Behind each of these companies is a leader or a couple of leaders who had the vision and the gumption to do something different. Thomas Stemberg took the business plan he wrote after getting fired from his job with a grocery chain and turned it into Staples, which has 25,000 employees. The $3 billion company he has created will be a $10 billion company by the year 2000. Herb Kelleher turned a hub airline into the powerful Southwest Airlines, which employs almost 20,000.

Some people think Federal Express followed the pony express, but in 1973 it was an idea rattling around in the head of Frederick W. Smith. Smith revolutionized the delivery business. When Bill McGowan and Bert Roberts at MCI dared to compete with AT&T; in the long-distance market, people laughed at them. For ten years, MCI lost money, but it has survived and succeeded. Because of MCI's competition, we all pay less for long distance.

Twenty years ago, Nucor was a small steel manufacturer whose embrace of a new technology called thin-slab casting allowed it to thrive when other steel companies were stumbling. Chairman Ken Iverson pays his workers based on the company's performance, and today Nucor is the country's fourth-largest producer of steel. By 2000, it will outproduce USX, which back when it was U.S. Steel was the first billion-dollar company in U.S. history.

Without small companies flourishing underneath the big companies, the U.S. could easily have 15 percent unemployment instead of the recently reported 5.6 percent. Then we'd be in worse shape than the countries of the EU, where large companies have resisted laying people off and where 19.6 million people (10.9 percent of the workforce) are out of work. By being paternalistic and refusing to cut costs and innovate, Europe's big companies have stagnated. Small companies are simply hard to find. The 2,740 small companies that have gone public in the U.S. in the 1990s are probably more than Europe has created in the nine centuries since Charlemagne.

My guess is we're in the seventh or eighth inning of downsizing, while Europe has just entered the second or third inning. They've begun the painful process that we are close to completing, and they're doing it with 20 million people already out of work. They'll need a stronger drug than Prozac to help them cope with the problems that lie ahead.

Of course, we don't lack for problems, either. Our overall economic growth has lagged the growth rates of other periods in our history, and our lowest-paid workers are bringing home a smaller paycheck (adjusted for inflation) than they did 25 years ago. We've got high crime and high unemployment in the inner cities, where half the children never finish high school. Our dropout problem deserves the kind of attention the layoffs have been getting, and business is not doing enough to help with a solution. There are next to no dropouts in Taiwan and Korea, and those countries will have a big advantage over the U.S. in the next century because of it.

But when it comes to job growth, ours is the most dynamic economy in the world. I think much of the pessimism about the 1990s may turn out to be misplaced.

Peter Lynch has written three books with John Rothchild; parts of this article are adapted from the most recent, Learn to Earn, published by Simon & Schuster. The opinions expressed in this article are strictly those of Peter Lynch and do not reflect the opinions of Fidelity Investments.

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