

Reviving Western Economies: Providing Answers in the Vacuum of Economic Ideas

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Introduction

With US official unemployment hovering around 9.5% in mid-2011, the US economy seems to be in a tailspin. The European Union seems to be in no better shape- with a looming debt debacle eschewing any hope for an economic recovery. Japan, also, continues its malaise from the 1990s, with little to show for its ongoing attempts to kickstart its economy.

The response of the Republican Party in the US, such as tea party pundits Eric Cantor, and the Cameron Government in the UK, has been to embrace a Milton Friedman view- that government needs to be minimized, particularly drastic cuts in spending, that low interest rates will solve the problem, and that “entrepreneurship” will magically arise from the private sector will magically appear. The response of some Democrats, meanwhile, as reflected in the NYT op-ed pieces of Paul Krugman, is to call for a major fiscal stimulus.

What I argue here is that both sides are grasping at straws. Both ignore the structural problems in the Western economy, and more fundamentally the historical facts about how economies grow. The cluelessness by economists is reflected in the vacuous nature of their methods- based most often on highly mathematical models of an abstract economy that ignore basic facts on the ground, and the interplay of historical and political factors that shape real world economies. A mathematical model can not consider the effect of a successfully democratic Iraq on markets, or the retirement of Steve Jobs. These factors are as important to economic functioning as the macroeconomic data are. We can begin to fashion a new understanding of the types of policies that would be needed to really kick start the economy, and job growth with it, in a new positive direction.

Why Old Economic Recipes are Half a Loaf

Economic discussions during the 20th century have been dominated by 2 main approaches to creating economic growth. During the Great Depression, through trial and error, the Keynesian approach of using government spending to stimulate economic growth was the main paradigm. The Keynesian approach was blamed by the 1970s for not being able to explain the existence of “stagflation,” or high unemployment and inflation. Along came Milton Friedman and the Chicago school of economics to put the emphasis on the need for tight control of the money supply. The Friedman approach was part of a general development that

changed the game from one in which the government was supposed to lead the economy out of recession to one in which it was to blame for it, echoes of which we hear today.

According to this view, which reached its intellectual apogee in the 1980s, the more we liberalize, privatize, and deregulate to allow free markets to operate, the better off we will be. The program seemed to work well as the US moved out of recession in the early 1980s to high levels of growth in the 1990s. The idea was, then, controlling the money supply was the key tool for government to either stimulate or cool down the economy, and therefore, government spending could be wound down with no harm to the economy. Growth would come from the private sector.

The crisis of the past 2 years and the lack of results from virtually zero interest rates shows that the Friedman approach is misguided. The deregulation of markets led to an irrational exuberance, to the point of creating moral hazard throughout the financial system in the form of securities, stocks, and real estate whose value is based on the speculation about trading profits rather than any concrete value in the real world. The list of disasters from wanton disregard of markets even led Alan Greenspan, one of the leaders of the movement, to admit he may have overestimated the power of self-correction in markets. The oil spill by BP in the Gulf abetted by lack of regulatory oversight is but one further example of how free markets fail.

The recognition that markets have failure led the Obama Administration to move back in desperation towards Keynesian solutions (for lack of any other ideas). The intervention in the financial and auto industries, and the stimulus program organized around infrastructure improvements could have been adopted by a modern day FDR. That general government spending, along with monetary loosening, have failed to resurrect the economy demonstrates the general flaw with the analysis so far, a flaw, we argue, based on a limited understanding of how economies really grow.

Looking at Growth Spurts in the Past for Clues About the Future

The role of the government is crucial for economic growth, but not just in the ways that the Keyensians and free market zealots would have us believe. Such approaches are based on one time, ad hoc solutions to the situations at hand, rather than any systematic understanding of the sources of growth. We build on the work of Joseph Schumpeter and Raymond Vernon here to argue that the economic growth has to be viewed as a series of cycles based on a long-term competition to improve technology.

A well-developed economy at any given point reaches a steady state. At some point, all the citizens of a country who can afford them will have horse and buggies, or whale oil lamps. What creates new growth in the economy, then? Economists tend to say growth comes from increases in productivity and from trade. If productivity increases, that means we produce the same goods for cheaper, so that should reduce prices and wages. If trade increases, that may increase demand for some goods, those being exported, but it will reduce demand for those that must now compete with imports.

So, the real trick to understanding economic growth is to understand how demand is created through the development of new products. With that demand growth comes along the new jobs to produce the new goods, even while the old jobs disappear. So, when electricity is created, a whole new sector and all the jobs for producing and distributing electricity are created. The same is true for automobiles and aerospace, or any other product.

My argument then is that US economic leadership through the 20th century, for a variety of reasons, was based on primarily on its leadership in creating new products that everyone wanted. Chris Freeman and Luc Soete's book *Economics of Industrial Innovation* provides a timeline of key inventions and technological leadership over the past 2 centuries that underscores this point. In the early part of the Industrial Revolution during the first half of the 19th century, leadership in the development of textiles and an iron casting industries were key to the dominance of the British Empire. By the 2nd half of the 19th century, however, the development of steam engines, railways and shipping showed an ascendant US power, on the basis of its innovative leadership in these areas. The early 20th century brought with it the development of a host of now essential products, including steel, electricity, automobiles, telephones, radio, petroleum and plastics, aluminum, and heavy chemicals. In all these areas, the US either had or shared technological leadership as well. We all know by heart that this is true, as we grow up with the heroic tales of Edison, Graham Bell, and Ford's forging of new industries. The mid-20th century was more of the same for the US, with the introduction of airplanes, pharmaceuticals, nuclear power, and electronics. If anything, the US was in an even more dominant position as its European rivals exhausted themselves in conflict. In the last 2 decades, the US has seen its lead in both these now mature products and in the emerging new products of biotechnology, information technology, and green technology increasingly under fire, as not only the European countries but also emerging giants such as China, Russia, India, and Brazil compete for leadership positions.

European leadership has similarly been challenged. One can not pose that the government is the problem when Scandinavian and the German economies, with far more extensive intervention than the US, have done better in terms of growth. The difference is that

these economies have more flexible, well-educated labour forces that have been able to shift into advanced niche products that are still competitive on the basis of quality and filling a need in global markets. A prime example is the advanced machinery that the German export boom is based upon. In the US, the UK, Japan, France, and the rest of Europe, there is, by contrast, a loss of competitiveness. The real estate boom from Japan to the US to Spain put capital into an asset bubble that led to consumer binge, rather than improving quality of labour force, productivity, and developing new products. If the US had directed this investment instead into reproducing products such as the iPhone, it could have maintained its lead. The iPhone is a perfect example of how an advanced country with high wages stays rich- by becoming an innovation leader.

Why is it so important to be a leader? What Raymond Vernon showed back in the 1960s was the first company in a new product area has an inherent and often lasting advantage. Where mature products such as t-shirts are subject to the economic theory presumptions of free market competition, new products are not, because, by definition, there are few producers. So, it is no mistake the Microsoft cements its monopoly position as the provider of operating systems with a new improved product launch every few years. But leadership does not always last. When someone produces a better product or the technology itself becomes outdated, the producer will lose his position and market share. With the introduction of the iPhone, Nokia's previously dominant position in mobile phones has been eroding. Similarly, the producers of typewriters no longer exist. Once leadership is lost, it is very hard to gain back- just ask IBM, who used to be a leading producer of PCs.

So, this brings us back to the question of how you gain technological leadership. In this question, government policies almost always play a crucial role. As Daniel Yergin points out in his celebrated history of the petroleum industry, *The Prize*, the US government bailed out the automakers not only in the 1980s and 2010, but also in the 1940s, when procurement helped to save the US auto industry from a severe slump. In terms of electricity, it was the public sector utilities that led to the electrification of the nation. In terms of aerospace, electronics, pharmaceuticals, and the Internet, US government support, directly helped to establish or maintain leadership. In fact, we can't think of a major industry, including the oil industry that did not receive major assistance either direct or indirect, in its establishment.

Technological Leadership is Fate

This brings us to the question of whether such leadership can happen under globalisation. Globalisation of production has certainly reduced the time and concentration in which a particular country can enjoy the monopoly position of the technological leader. It has also reduced the number of labor-intensive jobs that can be created. But it doesn't change the

basic economic laws we outline above- he/she who innovates, leads in prosperity and jobs. The leading producers of pharmaceuticals are still concentrated in the US and Switzerland. The leadership of Apple in producing the iPhone and iPad shows that made in America can still sell everywhere. The leading IT producer of chips, Intel, is still US-based.

However, the present malaise shows that new engines of growth, namely the new products and services that are needed, are still up for grabs. By all accounts, China has forged an early lead in green technologies, including wind power, high speed rail, and electric vehicles, as well as catching up in a wide variety of maturing industries from electronics to steel. India is continuing to push forward with its government supported push into software. And other competitors in a variety of areas are emerging- Brazil as reflected in its government-supported aircraft manufacturer, Embraer; Finland Inc. in the form of Nokia; and Singapore as a financial and biotech center.