Armchair Economics

Perspectives from an economic everyman

Clash of the Titans

November 2012

The past couple of decades have been an economic rollercoaster, during which prevailing economic theory seemed to shift with each twist and turn and climb up and plummet down the ride. We've seen the perspectives of several titans of economic theory fall out of fashion just as quickly as they came in. With each trending economic theory, its supporters earnestly believe their favored philosophy will finally bring the economic fix that's been eluding us. But none has. To date, none of the economic titans of the Industrial Era has shepherded our return to the path of prosperity.

Just five years ago, the world was concerned about Thomas Malthus' (1776-1834) predictions that population growth would outpace resource availability. Commodity prices doubled between the summer of 2007 and 2008. China and its emerging markets cousins were going to grow to the sky, depleting more and more of our dwindling resources along the way. Simultaneously, the developed markets had reached a Cinderella stage, with happy economic endings sustainable in perpetuity.

But of course all of this changed pretty fast. Little did we know how fragile the developed markets had become. As we now know, growth during the 2002-2007 period was actually stimulated by bad financial regulation instead of any organic economic catalyst.

The U.S. housing boom was a bubble created by the misallocation of capital. High credit risk borrowers were allowed to buy homes with nothing down and at lower and lower interest rates. People bought homes they couldn't afford. The European economic "miracle" was little different. In Europe, weak sovereign economies were allowed to borrow more and more money at rates that didn't match up with their credit risk. Two different types of liar loans, one consumer the other sovereign, fueled economic "growth" in the U.S. and Europe during the 2002-2007 period.

All this came crashing down after the Lehman bankruptcy. Malthus quickly fell out of favor; his fear of resource scarcity was supplanted by John Maynard Keynes' (1883-1946) fear of economic scarcity. Keynes postulated that when organic economic activity is weak, government should come to the rescue with substantive stimulus to jumpstart another growth cycle.

Gross Domestic Product (GDP) is traditionally measured by adding Consumption + Investment + Government Spending + Net Exports. When Consumption and Investment declined during the 2008-2009 recession, following Keynesian theory, government stimulus exploded in both developed and emerging market economies. It was the only way to hold up activity in the face of not just an economic recession, but also a potential financial institution meltdown.

Not long after, the developed market economies found themselves in a sovereign debt crisis. Keynesian stimulus had saved us from economic implosion, but the cost was sovereign debt explosion. Keynesian stimulus had turned into a Keynesian trap. Developed markets' economic "growth" became almost totally dependent on government fiscal and monetary stimulus. This dependency remains today. Budget deficits and money printing continue to rise.

As fear took hold that governments would not be able to pay back debts, the ball of economic theory was again passed. This time economists at the International Monetary Fund pushed an austerity agenda to the forefront of economic strategy.

Armchair Economic Perspective
Clash of the Titans
November 2012

Austerity as an economic policy is supported by a 2009 book, *This Time is Different*, written by economists Kenneth Rogoff and Carmen Reinhart. The authors' historical study came to the conclusion that once any country's debt-to-GDP ratio surpassed 90%, its economy would further falter and prospects of debt default would increase. So began the austerity movement in Europe, while the debate grows in the U.S. for a similar haircut of government expenditures.

This austerity path has led Europe back into recession. Greek protests are a regular occurrence, Spain's unemployment sits at over 20% and France is teetering on its own economic brink. With nothing else to take up the slack when government spending is reduced in the GDP equation, there can be no growth. Taking from one input while not adding to another only reduces overall economic activity.

So where is the creative destruction that Joseph Schumpeter (1883-1950) suggested could keep economies growing? Surely there is another innovation explosion about to propel us to ever more prosperity.

There are two challenges with Schumpeter's creative destruction theory. For one, innovation is always happening, but most of it is incremental to something that previously provided substantive economic stimulation. The iPhone and iPad are perfect examples of incremental innovation. They are just expanding upon previous innovations that were the true economic stimulators – the PC, cell phone and Internet. Incremental innovations provide less economic fuel than their core technologies. Nikolai Kondratiev (1892-1938) made this argument with his long wave innovation cycle theory before Joseph Stalin put him in prison to die.

In addition, can creative destruction really work without destruction? Destruction is a loathsome thought to any Keynesian and certainly any government or politician dependent on voters to keep them in power. In the developed market "democracies," Schumpeter's destruction can only be allowed to happen to a very small voting minority. The rest of the voters need to hear "we got your back" and "we'll make it easier" in order for politicians to win elections and for governments to maintain the confidence of their citizens.

Ayn Rand (1905-1982) is surely rolling in her grave, as the state now controls so much of our lives. Rand's Objectivist philosophy suggests that the only moral social system is the full respect of individual rights embodied in laissez-faire capitalism. But today capitalism is under attack by an ever more government-managed economy and those who advocate for it. Friedrich Hayek (1899-1992) too is probably roiling the earthworms, as we are witnessing developed markets shift from "free" to "better managed" economies. Hayek's *The Road to Serfdom* seems to be playing out today in real time.

Most recently, Milton Friedman (1912-2006) argued against heavy-handed government intervention into the private sector. Along with Rand and Hayek, Friedman felt that too much government stifled private economic activity. Today's supporters of this theory suggest that government growth is suppressing private sector growth, but is that confusing causation with correlation? Has private sector growth slowed because government has grown, or has government grown because the private sector has slowed? Might growth in government naturally occur with private sector slowdown?

Keynesian stimulus, administered during cyclical recessions, by definition necessarily increases the size of government. Each time our economy stumbled over the last century or so, government naturally grew as stimulus was applied to treat our lethargy. Government growth seems a natural consequence of private sector malaise. At some point, government's growth may stifle private sector initiative, but we should at least acknowledge that government (Keynesian) stimulus inherently grows government.

Armchair Economic Perspective
Clash of the Titans
November 2012

Stimulus, austerity, increasing the size of government, reducing the size of government – which should it be and why? Maybe we are focused on the wrong economic symptoms. Maybe we should go back to the Industrial Revolution's early days to consider another economic theory.

In the early days of industrialism, Luddites fought the growth of industrialization in English textile mills. They worried that machines would replace labor. Their fears eventually proved unfounded, as an enormous amount of forthcoming invention created many more jobs while simultaneously increasing everyone's standard of living. This pattern has repeated for at least a couple of centuries.

But might Luddite fears now be coming home to roost?

These Armchair essays started four years ago with a light bulb moment…Technology is destroying jobs faster than our natural economy can replace them.

Jobs are being destroyed because technology has enabled entire new labor forces in emerging markets. Cheap emerging market labor is replacing expensive developed market labor for many production-oriented tasks. This follows David Ricardo's (1772-1823) rules of comparative advantage. In an open system, resource utilization will naturally fall to those with the cost-benefit advantage.

In addition, jobs are being destroyed as automation replaces more and more labor. This is more classical Luddite and the most worrisome issue to the Armchair. As labor's input into agriculture decreased during early industrialization, displaced workers found a natural home in the production processes. Labor moved from the rural farms to the urban factories. This in itself was highly simulative, as infrastructure, like cities, wholesale energy production, transportation and communication systems, needed building.

Now that production processes are being mechanized, where will labor find a home? Not everyone can be an iPad app or production automation designer. And as the last decade of income stagnation has proven, the shift from a production to a service oriented economy produces lower wages. Service job growth is not the answer. Perhaps our next round of economic policy will be driven by Luddite theory, as developed market economies seek to grow respectable, paying jobs.

In the past few decades, we've seen a clash of the economic titans, with no one theory directing us to a clear-cut solution to our puzzling economic paralysis. Might this be pointing us to one conclusion? *Maybe looking back doesn't always provide a productive reference point to looking forward*. Economy isn't so easy to understand, especially during structural change periods, which we seem to be undergoing. We have passed through the Industrial Revolution era, when the titans of economic theory ruled. But they are now failing us in an economy being shaped by new technologies. Will these times produce a whole new set of titans?

Douglas A. Leyendecker
713-862-3030
doug@armchaireco.com