Growth STRATEGIES

Trend Analysis That Builds Business Decisions

LA JOLLA INSTITUTE
Steve PonTell

Dr. Roger Selbert, Editor & Publisher
E-mail: roger@rogerselbert.com

2118 Wilshire Blvd., #826 • Santa Monica, CA 90403
Telephone: (310) 721-6322 • Facsimile: (310) 828-0427

IN THIS ISSUE: ECONOMICS MADE INTERESTING!

1 – ECONOMICS DOES NOT LIE

Though economics as a discipline arose in Great Britain and France at the end of the eighteenth century, it has taken two centuries to reach the threshold of scientific rationality. This has finally brought economists to a broad, well-founded consensus about what constitutes good policy. So writes Guy Sorman in *City Journal*.

Almost all top economists – those who are recognized as such by their peers and who publish in the leading scientific journals – would endorse the following 10 propositions. The more the public understands and embraces these propositions, the more prosperous the world will become.

1. The market economy is the most efficient of all economic systems. Market mechanisms are so efficient that they can manage threats to long-term development, such as the exhaustion of natural resources, far better than states can.

2. Free trade helps economic development. Free trade not only generates the greatest possible growth; it tends to distribute it widely, both within nations and among them.

3. Good institutions help development. All economists acknowledge today that economic development requires an independent and reliable legal system to enforce contracts and ensure fair competition. Institutions that improve market transparency are particularly important.

4. The best measure of a good economy is its growth. Unlike other proposed measures (happiness, for example), economic growth can be determined objectively: it is the rate of increase in a country's gross domestic product (GDP) over a given period. There may be wide agreement that GDP omits important aspects of economic activity, but all economists agree on growth's importance.

5. Creative destruction is the engine of economic growth. The ceaseless replacement of the old with the new – driven by technical innovation and entrepreneurialism, itself encouraged by good economic policies – brings prosperity, though those displaced by the process, who find their jobs made redundant, can understandably object to it.

6. Monetary stability, too, is necessary for growth; inflation is always harmful. Inflation destroys entrepreneurship, slows growth, and generates social inequality. The best way to restrain inflation, economists now understand, is to transfer money management from governments to independent central banks like the Federal Reserve and the European Bank, which – monetarists all, these days – try to create only enough credit to provide liquidity and prevent the financial panic that often accompanies credit crunches.

7. Unemployment among unskilled workers is largely determined by how much labor costs. So regulating the labor market (with a minimum wage, for example) adds to labor costs, economists acknowledge, and increases unemployment.

8. While the welfare state is necessary in some form, it isn't always effective. Economists recognize that government assistance always produces incentives that may affect, for good or ill, recipients' behavior and well-being. The key is to avoid making individuals and groups dependent on state assistance, locking them into sustained semi-poverty.

9. The creation of complex financial markets has brought about economic progress. These sophisticated instruments, like derivatives, have facilitated risk-sharing on a global scale, boosting innovation and hence prosperity. The debate among economists today concerns only the degree of transparency and regulation necessary for their effective functioning.

10. Competition is usually desirable. Beyond that, there is no unanimity: some economists believe that under certain circumstances, a private or public monopoly may contribute to innovation or progress. What kind of protection to extend to intellectual property is also disputed.

These ten propositions should guide all economic policymaking, and to an increasing degree they do, worldwide, writes Sorman. The free market still has enemies and critics, ranging from those who dream of a world more just, more spiritual, or transformed in some other utopian way. And we must not overlook ignorance: economic principles aren't widely understood among the public or even among lawmakers.

In the future, an essential task of democratic governments and opinion makers – when confronting economic cycles and political pressure – will be to secure and protect the system that has served humanity so well, and not to change it for the worse on the pretext of its imperfection. This lesson is doubtless one of the hardest to translate into language that public opinion will accept, concludes the author. The best of all possible economic systems is indeed imperfect. Whatever the truths uncovered by economic science, the free market is finally only the reflection of human nature, itself hardly perfectible.

2 – HOW ARE WE DOING?

The American economy is in a rough patch. But the long-term trends are good – and there is a price to economic pessimism. So write W. Michael Cox and Richard Alm of the Federal Reserve Bank of Dallas.

When a presidential election year collides with iffy economic times, the authors point out, the public's view of the US economy turns gloomy. Perspective shrinks in favor of short-term assessments that focus on such unpleasant realities as falling job counts, sluggish GDP growth, uncertain incomes, rising oil and food prices, subprime mortgage woes, and wobbly financial markets. Taken together, it's enough to shake our faith in American progress.

But it is a mistaken view. The best path to reviving that faith lies in gaining some perspective – getting out of the short-term rut, casting off the blinders that focus us on what will turn out to be mere footnotes in a longer-term march of progress. Once we do that, we see the US economy, a $14 trillion behemoth, is doing quite well, thank you very much. The authors cite the following evidence to bolster their view:

The American economy has been remarkably stable and productive. Since 1982, the United States has been in recession for a mere 16 months, the present slowdown notwithstanding. Over that period, the country more than doubled its inflation-adjusted output of goods and services and created jobs for an additional 50 million workers.

The spread of products into American households has been phenomenal. Products that begin as luxuries only the rich can afford in time come within the means of just about all US households. In previous generations, telephones, cars, electricity, household appliances, and televisions made life better for the average American. In our times it has been computers, cell phones, Internet access, VCR/DVD players, digital cameras, and more.

All segments of society have shared in the material progress. Over the past two decades, ownership of cars, color televisions, and household appliances has risen among poor households. A quarter of poor households have computers. Two in five own their homes. For many goods, ownership rates are higher for today's poor households than for the general population of the early 1970s.

Less work buys more stuff. When it comes to how hard we have to work for food and fuel, we still face far lower burdens than our grandparents did. Living standards rise on the ability to use productive resources to churn out more goods and services – that is, to advance productivity. As the economy has become more productive decade by decade, Americans have reaped the gains, first and foremost by consuming more.

We've also gained more leisure time, improved our working conditions, enhanced safety and security, and added variety to our choice set. All of these benefits become increasingly important as we climb up the income ladder.

- An average workweek has fallen from 39.8 hours in 1950 to 36.9 hours in 1973 to 33.8 hours today.
- Not all those hours are spent on actual work. Human resources experts estimate that 1.6 hours a day go to non-work activities; employees themselves say it's more than two hours. What are workers doing? Most of them are using the Internet for personal business or socializing with coworkers.
- Since 1950, the annual hours devoted to work at home has fallen from 1,544 to 1,278. Working less means we have more time for ourselves. All told, only about a quarter of our waking hours are consumed with work, down from 45% in 1950 and 35% in 1973.
- Workplaces are getting safer. In the early 1990s, the on-the-job death rate fell below home mortality for the first time. Since then, the home has become riskier, while safety gains have continued at work
- Deaths per billion miles driven and flown are both at all-time lows.
- Medical advances have brought down death rates for many diseases. Gains have been made against heart disease and cancer in recent decades. Since 1960, life expectancy has risen by seven years for men and six years for women.

The American economy is still highly competitive internationally. The world economy is moving toward producing and consuming more services – and that's where the United States shines. Our foreign sales of services totaled $488.5 billion in 2007, topping the combined total of Britain and Germany, the second and third most successful services exporters. US exports exceed imports in 15 of the Commerce Department's 20 broad categories of services trade, often by large margins.

This trade supports well-paying jobs in industrial engineering, medicine, construction, information technology, and law.

CONCLUSION: THE PRICE OF PESSIMISM

So many data points add up to steady, continuing progress for average Americans – and there's no reason not to expect the future will bring further progress. Bad news will pop up from time to time, just as it has in every decade of American history. Some people will take the negatives – the hiccups on the long road to progress – for harbingers of worse times to come.

But there's a price for pessimism. In the early 1980s, the US economy had big problems, including slow growth and high inflation. A rational response for pessimists might have been to put their money into the safe havens of gold or Treasury bills. A $10,000 initial investment in gold would now be worth $22,525; the same amount in T-Bills would be worth $37,778. But

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the same $10,000 invested in Dow stocks would now be worth $228,163, even after the financial market troubles of recent months.

The lesson seems clear enough: don't sell the American economy short.

3 – ECONOMICS AS METAPHOR

Although markets are volatile and segments of the country are having a hard time, the national output is up, not down, this year. How has the economy pulled this off? Is there something the pessimists were missing?

The answer is yes, writes David Ranson, head of research at H.C. Wainwright Economics: People tend to anthropomorphize the world around them, and not just in economics. We look at the outside world and assume that it is governed in the same way as our own lives.

The same parochial streak in human nature is rife in economic commentary. In the context of a household or a business, debt is a burden and can become a threat. But for society as a whole, debt finance is a prime means of capitalizing production and growth.

It's extraordinary, then, writes Ranson, that in national debate the narrow view drowns out the broad. Aggregate private debt and trade deficits are widely regarded with equal suspicion and fear – even by "experts." Instead of celebrating the role that private debt has played in creating prosperity, many blame "excessive" debt when things go wrong, and cite it as a basis for pessimism.

At the micro level, the failure of an institution is often a disaster to those with a personal stake. But from an overall perspective, when one institution becomes insolvent, another can be relied on to pick up its functions.

Again, it's the localized human costs that exercise the political imagination. The benefits of systemic adaptability are taken for granted. Government responds to constituencies and takes great pains to preserve the existing institutional structure, sometimes guaranteeing or bailing out failing firms. It's widely assumed that a large enough wave of bankruptcies will bring the economy down. Little or no credit is given to the ability of the economic system to heal itself and find its way back to vitality.

What's excessive now is fear, not debt: Fears of insolvency and private-sector indebtedness are misplaced and harmful. They place obstacles in the way of ill-used capital that seeks to move toward safer and more profitable employment. They plunge the stock market into turbulence. They push government into hasty actions that intrude more aggressively into private choices and decisions. They undercut the market-price system, without which the economy cannot allocate resources productively. Last but not least, these fears trigger the proverbial false alarm in a crowded theater, sending everyone stampeding for the exits.

A natural system has built-in redundancy. It manages and heals itself. The economic system is no exception. Failure to recognize this endangers the mental health of our society. We create a far bigger tragedy when we lose heart, change the rules of the game, or act recklessly with quick fixes. We are not a nation of whiners, but we do have a lot of alarmists. It is becoming politically incorrect to suggest that the economy is basically sound.

Economists have a professional duty to transmit the more broad-minded vision of the world that their discipline reveals. A more objective diagnosis is especially needed during an election year, in which many unfounded fears are broadcast and amplified by the media.