Growth
STRATEGIES

Trend Analysis That Builds Business Decisions

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1 – THE VIRTUOUS CIRCLE

There is said to be a general consensus, among politicians, economists and voters all, that large amounts of public sector spending are necessary and appropriate in current economic circumstances. There is not such a consensus; more than 350 economists of note have expressed their opposition (http://www.cato.org/special/stimulus09/cato_stimulus.pdf). But even if there were such a consensus, where does the wherewithal to undertake such spending originate? It originates in, and only in, the virtuous cycle of economic growth.

In the virtuous cycle of economic growth, a favorable business climate begets private sector business growth, which leads to profit growth, which makes employment and income growth possible. Private sector business and job growth, income and profits are the only real sources of tax revenue growth, from which governments pay for services (such as infrastructure, education, and transfer payments).

The benefits of economic growth extend far beyond supplying the public sector with the means to provide services. Economic growth means higher standards of living and rising quality of life. In short, things get "better:" people lead healthier, longer lives; the quality and quantity of affordable goods and services increases; there is less poverty and deprivation, more opportunity for individual and collective improvement. There is more charitable giving; environmental conditions improve (the richest, fastest growing economies are also the cleanest); there is a more robust middle class. (Research suggests that more money does not necessarily make people "happier" after a point, but is it not better to be unhappy in comfort?)

Economic growth is also the most effective social lubricant going. It really is true, as JFK said, that "a rising tide lifts all boats." Riots do not tend to occur in robustly growing economies where economic opporunity is widespread. When the economy is growing, people are also more generous, tolerant, forgiving, understanding, even moral. In other words, to utilize another useful expression, economic growth "hides a multitude of sins."

It is important we not lose sight of this most important variable in our discussions of poltics, policies, society and trends: economic growth.

2 – THE GROWTH IMPERATIVE

The impact of the stimulus and bailout plans on long-run economic growth has received little attention so far. This is unfortunate. Economic growth deserves our attention not only because of its significance for human welfare, but also because many aspects of growth, including its main sources, are reasonably well understood. So writes Daron Acemoglu, Professor of Applied Economics at MIT.

INNOVATION, TECHNOLOGY, REALLOCATION

We have enjoyed prosperity during the past two decades because of rapid innovations quite independent from financial bubbles and troubles, writes the author. We witnessed a breakneck pace of new innovations in software, hardware, telecommunications, pharmaceuticals, biotechnology, entertainment, and retail and wholesale trade. These innovations are responsible for the bulk of the increases in aggregate productivity and wealth creation that we had in the past 20 years.

Even financial innovations (somewhat in disrepute in the recent crisis), we are reminded, are in most cases socially valuable and have contributed to growth. True, complex securities were misused to take risks with the downside borne by unsuspecting parties. But when properly regulated, these innovations also enable more sophisticated strategies for risk sharing and diversification. They have enabled and will ultimately again enable firms to reduce the cost of capital.

Innovation and technological ingenuity are the keys to the prosperity and success of the capitalist economy, according to Acemoglu. Of course, innovation often comes in the form of creative destruction – the continual and constant displacement and replacement of production processes and firms.

POLITICAL AND POLICY CONSIDERATIONS

The politics of growth is no simple matter, therefore. Creative destruction and reallocation not only harm established businesses but also their workers and suppliers. This dynamic can reduce the enthusiasm that many people have for economic growth and for its institutional foundations (such as property rights).

We should not let this deteriorate into a backlash against capitalism itself, rather than the specific practices that were problematic, writes Acemoglu. The design of policies to contain and end the global crisis ought to pay special attention to the implications of policies for both long-run economic growth and for the politics of growth as well.

Steps taken in Washington should specifically refrain from policies that create barriers against necessary reallocation and reduce incentives to innovate, he counsels. While greater regulation is likely and in some areas necessary as we move forward (particularly in the financial sector), the regulation pendulum can easily swing too far as voters and policymakers become more convinced that free markets are responsible for the economic ills of today.

The innovative dynamism of the United States and world economies is still strong, and Acemoglu hopes that policymakers have learned from mistakes and will strive for smart regulations. But he fears since the rhetoric of the past two decades equated capitalism with lack of regulation, that there will be plenty of politicians only too happy to exploit the frustration of those who are bearing the brunt of the crisis.

3 – DEREGULATION = PROSPERITY

Deregulation is getting a lot of misplaced blame for our current economic calamities. But as John Berlau of the Competitive Enterprise Institute explains, deregulation made the prosperity of the 1990s possible:

> Now that he has won the presidency and must shift from campaigning to governing, Obama and his economic team will have to face up to a paradox that most of the media overlooked during the campaign. Namely, the Obama campaign's twin messages of bashing deregulation and embracing the Clinton years were inherently contradictory. Bill Clinton signed nearly every deregulatory measure that John McCain backed – the same measures that are now being blamed (wrongly) for helping cause the current crisis. What's more, Clinton administration officials have credited these policies for contributing to the '90s economic boom – the very "shared prosperity" that Obama says he wants to go back to.

If Obama follows through on his campaign rhetoric on regulation, it will not be the Bush economic policies he will be overturning. In the financial area, ironically, Clinton was actually the more deregulatory president.

Take Gramm-Leach-Bliley, the 1999 law Clinton signed repealing the Depression-era Glass-Steagall Act, which had strictly separated traditional commercial banking from investment banking. Obama's supporters claimed that getting rid of Glass-Steagall led to the credit blowup. But then-Clinton Treasury Secretary and now-Obama adviser Larry Summers had a different view. Summers told *The Wall Street Journal* in 1999 that the new law would spur economic growth "by promoting financial innovation, lower capital costs and greater international competitiveness."

What's more, Clinton himself defends the law to this day. In a recent interview Clinton said plainly, "I don't see that signing that bill had anything to do with the current crisis." He even added that its lifting of barriers to financial service mergers may have lessened the crisis' impact.

Summers and Clinton were – and are – correct. The law benefited the economy by creating more choice and competition, and there is little evidence of Glass-Steagall's repeal playing a role in the mortgage crisis. As the American Enterprise Institute's Peter Wallison noted in *The Wall Street Journal*, "None of the investment banks that have gotten into trouble – Bear, Lehman, Merrill, Goldman or Morgan Stanley – were affiliated with commercial banks." He also pointed out that "the banks that have succumbed to financial problems – Wachovia, Washington Mutual and IndyMac, among others – got into trouble by investing in bad mortgages or mortgage-backed securities, not because of the securities activities of an affiliated securities firm."

Even stranger than the Obama camp's attack on McCain's support of the bipartisan Gramm-Leach-Bliley was their slap at his support for a bill that cleared barriers to interstate banking. This law, the Riegle-Neal Interstate Banking and Branching Efficiency Act, was passed in 1994, before Republicans even took over Congress.

Riegle-Neal finally allowed the U.S. to have nationwide banking chains, as virtually every other developed country does. Federal Reserve Governor Randall Kroszner has credited the law for a myriad of economic benefits including "higher economic and employment growth, spurred by more-efficient and more-diverse banks" and "more entrepreneurial activity, as the more bank-dependent sectors of the economy, such as small businesses and entrepreneurs, achieve greater access to credit."

If President-elect Obama wants to pull the U.S. economy out of its rut, he must face up to the fact that '90s deregulation was an essential ingredient in Clinton's recipe for an economic boom. He also must recognize that substantially undoing the liberalizations that Clinton and the GOP Congress achieved would crimp recovery as well as create new problems

Deregulation has never meant non-regulation. Creating a modernized regulatory regime for some of the new challenges we face would have been an urgent task of any new administration, but the key is what type of updating would be done. Good updating would take into account government subsidized institutions – such as Fannie Mae and

Freddie Mac – that have weakened market discipline, as well as existing regulations that encourage perverse incentives, such as Clinton's expansion of the Community Reinvestment Act, an area where the administration was not deregulatory and actually encouraged bad loans to be made.

Nevertheless, the Clinton-GOP governance, despite the constant bickering and backbiting, ironically left a shining legacy of prosperity, which bipartisan deregulation was so much a part of. In terms of economic growth, there are few better examples of bipartisan success than this tenure.

4 – GROWTH: A WINNING POLITICAL ISSUE

Arguably at no time in their lives have more Americans been this sharply focused on the economy. They think and talk about nothing else. What are the political implications? Daniel Henninger writes in *The Wall Street Journal* that Republicans have been handed on a tarnished silver platter the chance to offer the American people an alternative vision of how their economy works – and grows. He advises that they should take political ownership of the 75% of the U.S. economy that the Democrats have abandoned – the *private* economy.

Over the past four decades and the decline of private-sector industrial unions, writes Henninger, professional Democrats – politicians, intellectuals, campaign professionals, unions and satellite groups – have severed their emotional and intellectual connection with private production. Today, frontline Democrats see the private sector as doing two things: It produces tax revenue for $3.9 trillion federal budgets, and it shafts workers. The private sector in the Democratic worldview is necessary but nasty. Their leadership gives the impression of not having the simplest understanding of how an employer's life unfolds day to day.

What Ronald Reagan knew and they don't, writes Henninger, is that what moves a nation is the vital, teeming life of the private economy – work, ideas, innovation, the excitement of production, getting bigger. *Growth*. In the past this world was depicted as blast furnaces and factory chimneys. Today the economy's sinews are harder to see, but they exist in tens of thousands of small-cap, mid-cap and fat-cap companies.

The Republicans, writes Henninger, must rediscover a way to talk about the living world of the real economy. Their vocabulary now consists mainly of policy-wonk spinach – "fiscal responsibility," "reduce the debt," and even "tax cuts." True but insufficient.

Don't be embarrassed, he counsels. Don't be embarrassed about embracing the world of free markets, competition, entrepreneurship and profit. If you don't know how to talk about it, reread the apostles and evangelists of private economic growth – Ronald Reagan's *A Life in Letters*, Milton Friedman's *Free to Choose*, Henry Hazlitt's *Economics in One Lesson*. Concludes Henninger:

> Politics, it has been recently demonstrated, is about ideas and language. The conservative movement is not at a loss for proven ideas, and in the US the most powerful of these – running in an upward line since the Industrial Revolution – is the idea of private economic growth. The Democrats don't want the private economy anymore and conservatives have forgotten how to talk about it. Democrats are betting their opponents will forget even where Ronald Reagan is buried. They should be so lucky.