Economic Stimulus without Industrial Policy Won't Work (Feb 2009)

Consumer activity accounts for about two-thirds of Gross Domestic Product (GDP). The theory of economic stimulus is to put money in the hands of consumers who go out and purchase goods and services. This burst of purchasing jump starts domestic industries which ramp up production and hire more workers to meet the increased demand. Unfortunately, an economic stimulus like this had a greater chance of being effective in the past than it does now because much of the production of consumer goods for the U.S. market was domestic, but now much (or most) of it is offshore.

For example, suppose U.S. taxpayers receive their rebate/stimulus and decide to replace some of their worn out or obsolete consumer goods. They pick American brands they are familiar with and buy a new Proctor-Silex toaster, a Cusinart Blender/Food Processer, a Black & Decker Dustbuster, and two new HP Pavilion Desktop computers and printers (In fact, we made these purchases recently.) Unfortunately, this is not going to stimulate domestic production and create jobs here because these products are all manufactured in China.

As U.S. companies have moved manufacturing offshore so they could produce more cheaply and have an price advantage for selling these products in the U.S. market, their lobbyists have told us how the American standard of living has risen because of access to much cheaper consumer goods produced offshore. They did not tell us that this is fundamentally a short-term benefit and that once these productive technologies have been moved out of the United States, the wealth which comes from adding value to inputs to make products would no longer accrue to Americans and that these wealth-creating activities could erode or disappear in the United States. Eventually, no matter how cheaply American companies could produce consumer goods offshore, Americans would not have the means to buy them.

Unfortunately, As Clyde Prestowitz writes in *Three Billion New Capitalists* (2005), "Once factories or industries are gone, they almost never come back. The cost of a restart is enormous and the competitive circumstances usually worse (p. 210). He cites "Other industries [which] simply disappeared" (p. 127) and "many imported products [which} are simply not made in the United States." (p. 214) He implies that "the U.S. manufacturing base may have atrophied to the point that it no longer has the capacity to respond" to a burst of consumer spending from a stimulus package. (p. 214)

What this shows is that, despite its energy and creativity, capitalism in a laissez-faire environment (which has been in vogue since the Reagan Administration) can be myopic and lead us off a cliff. Consider this example: Company A, an American manufacturer of PCs, moves its manufacturing to cheaper regions offshore. This gives it a price advantage for selling in the most lucrative market in the world, the U.S. market, and its CEOs look better than competitors in quarterly earnings reports. Then Companies B, C, and D have to follow suit and move their manufacturing offshore to stay price competitive in the U.S. market with Company A and look good on quarterly earnings. As companies have myopically pursued this strategy (always with an eye on quarterly earnings), they apparently haven't noticed that as they have continued to do this, they have taken away from the American worker the value-added manufacturing capabilities that created much wealth in this county and made the U.S. market so lucrative and attractive.

So where do we stand. We have tried laissez-faire capitalism twice in the twentieth century -- during the 1920s and in the decades since the Reagan Administration -- and twice it has led us off a cliff. We need government economic policies which harness the energy and creativity of the private sector but which guide it and prevent it from self-destructing. Paraphrasing George Soros, Prestowitz writes, "Far from being self-correcting, he [Soros] emphasizes, markets tend to excess. They overshoot." (p. 192)

What we need goes by several names: an industrial policy or an economic strategy (Prestowitz, p. 217) or a competitiveness policy ((Prestowitz, p. 256) or even at times mercantilism. Yes, Ronald Reagan scoffed at government's ability to "pick winners," but look where his laissez-faire policies have left us. Prestowitz writes, "Economists policy-makers in Europe and Japan accept the legitimacy of and the need for an economic strategy. They accept the notion that the structure of the economy has a significant influence on its long-term performance and must therefore be studied and attended in policy. In both regions there are officials whose job is to worry about economic structure and how various legislative and regulatory proposals might affect it." (p. 217)

The above quote should also include China. *Newsweek* reports that "The Middle Kingdom's blend of communism and capitalism gives it an edge in tough times." (January 19, 2009, p. 38) China exploits the energy and creativity of capitalism, but prevents it from leading the nation over a cliff. While, "it [the state] has unleashed a private sector that now controls at least half the economy, and as much as 70 percent if you include state-owned companies that operate as private firms," "The state still exerts a strong and stabilizing hand." China's economy is expected "to grow more than 7 percent in 2009."

The Obama Administration is apparently aware that if the stimulus package just puts money directly in people's pockets, they will likely spend a goodly portion of it on consumer goods made offshore. So they have proposed using the stimulus for infrastructure projects like repairing roads since this work has to be done here; it can't be done in China. However, the infrastructure approach has some insufficiencies: Firstly, even if the work by its nature has to done locally, when the workers are paid and decide to buy a new flat-screen TV, the stimulus will be offshore, not domestic. Secondly, the U.S. needs to import many things, e.g., petroleum, and the only way we obtain these items and at the same time increase our wealth is to export more than we import. We can't get wealthy building roads or houses for each other. We need to export value-added products, and to regain this capability we need an industrial or competitiveness policy. Economic stimulus alone won't work.

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