Industrial Policy

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Industrial policy is defined in the Chairman's letter of invitation as the coordination of Federal fiscal, monetary, trade, regulatory, anti-trust and R&D policies. Coordination would be achieved by an organization like Japan's MITI. A related proposal calls for the creation of a government development bank to lend money at below market rates of interest to fast growing firms in technologically advanced industries, for the purpose of encouraging growth, and to firms in declining industries with the intention of smoothing the decline.

I believe that the proponents of industrial policy (1) misinterpret the recent industrial history of the U.S., (2) misunderstand what has happened in the world economy, and (3) misread the experience with industrial policy elsewhere. Further, this type of industrial policy is insuitable in a society of free men. Industrial policy shifts control of resource allocation and investment from the market place to government agencies and delegates decision making power to political appointees allegedly representing labor, capital, consumers and other interest groups. This method of allocating resources is more suited to a corporate state, like Italy under Mussolini, than to an economy that seeks to achieve efficiency and freedom. Countries with industrial policy typically restrict capital movements and regulate interest rates as in Japan during the fifties and sixties, in Britain until 1980, and in France today.

My opposition to industrial policy does not mean that I believe current arrangements are ideal. I do not. Changes are needed. I offer some proposals for changes after commenting on industrial policy.

Recent Industrial Experience of the U.S.

The typical brief in favor of industrial policy attributes our slower growth to a lack of

planning. A typical claim is that the United States has been "deindustrialized" by growing competition from foreign countries and by their ability to increase their industrial production by diminishing ours.

These claims are not correct. We have not been "deindustrialized". The growth rate of industrial production in the United States slowed in the seventies. But, as Table 1 shows, all major developed countries experienced slower growth in the seventies.

Table 1
Growth Rates of Industrial Production

	1963-72 (1)	1972-81 (2)	Percentage Decline (2)-(1)	Rank
Belgium	4.4	1.2	73%	7
Canadian	6.1	2.6	57	3
France	5.3	1.6	70	6
Germany	4.9	1.1	78	8
Italy	5.1	3.2	37	1
Japan	12.0	3.6	70	6
Netherlands	6.5	2.1	68	4
Sweden	5.1	0.7	86	9
Switzerland	4.6	0.3	93	10
United Kingdom	2.8	-0.2	107	11
United States	5.1	2.6	49	2

Source: Federal Reserve Bank of St. Louis, *International Economic Conditions* June 1983.

Growth rates for industrial production show that, during the period 1963 to 1972, U.S. industrial production rose at a rate comparable to the growth rates experienced in the developed countries on the European continent, but that rate was less than half the growth rate of industrial production in Japan. In contrast, during the nine years ending in 1981, growth of U.S. industrial production is above the average for the developed, industrial countries.

All the developed countries experienced a decline in the growth rate of industrial production during the seventies. The oil shocks, rising inflation, rising protectionism, increased taxation to

support consumption and transfer payments and increased uncertainty about monetary, fiscal and trade policies are prominent among the reasons offered to explain slower growth. Whatever the reasons, it is clear that the U.S. has not suffered a relative decline.

Table 1 shows that the percentage decline in the growth of industrial production in the U.S. is smaller than in most developed countries. Japan experienced a much larger relative and absolute decline in growth. On average, the growth of Japanese industrial production is now much closer to the U.S. rate of growth.

Differences in the timing of recessions and recoveries in specific industries and other well-known problems of cross-country comparison suggest that we should not overstate the importance of small differences. Changes in the starting or ending dates would probably alter the relative rankings. Such changes are unlikely to alter the two main conclusions I draw: First, the decline in growth rates affects all developed countries; Second, Japan did not avoid the world problem but, in fact, the Japanese growth rate declined relative to United States'.

Data for real income include income earned in the provision of services, in agriculture and other productive activities. These data, shown in Table 2, support a stranger conclusion. The U.S. has the smallest relative and absolute decline in growth of real income among the eleven developed countries. Japan has the largest absolute decline and one of the largest relative declines. Japan's record of growth is impressive, but the differences in growth rates between Japan and the U.S. have become smaller. Whatever MITI or Japanese policy achieved, it did not prevent a decline in Japanese growth toward the world average.

Table 2
Growth Rates of Real National Product

	1963-72 (1)	1972-81 (2)	Percentage Decline (2)-(1)	Rank
Belgium	5.0	2.3	54%	8
Canada	5.6	3.3	41	3
France	5.5	2.5	54	8
Germany	4.5	2.3	49	5
Italy	4.5	2.9	36	2
Japan	10.5	4.4	58	10
Netherlands	5.4	2.8	48	4
Sweden	3.8	1.8	5.3	6
Switzerland	4.1	0.8	80	11
United Kingdom	2.8	1.3	54	8
United States	4.0	2.7	32	1

Source: See Table 1.

Changes in the World Economy

In a competitive economy with freedom to transfer capital to countries where anticipated returns are highest, the less developed countries typically acquire capital from the more developed countries. The flow of capital, if invested in efficient enterprises, reduces the difference in anticipated returns, increases income in the less developed countries and reduces differences in real wages between more developed and less developed countries. Measured growth rates would probably rise in the less developed countries, for a time, reflecting the increase in their level of income. If the process continued without hindrance, real wages and real rates of return would, eventually be equalized and incomes would move toward equality.

In practice there are many reasons why wage rates, incomes and rates of return are not equalized. Risk and uncertainty of return differ, and the differences are reflected in premiums that affect interest rates across countries and over time. Tax rates, regulations, social customs and attitudes differ also.

The tendency of capital to move toward highest after-tax, risk-adjusted real rates of return and for real wages to rise rapidly in market oriented, developing economies is clearly shown

by the data for recent years. Japan, Taiwan, Korea, Malaysia (and other developing countries) have imported capital from the more developed countries by providing higher anticipated rates of return. The opposite side of this capital movement is that the developing countries export more goods and services than they import.

The fact that countries like Japan, Korea, Taiwan or, in its better days, Brazil move from technologies that are more labor intensive (textiles) to technologies that require more skill and have greater productivity per hour (microprocessors) or to technologies that are labor saving (robots) is the expected result of development. Growing competition in industries with advanced technologies is the expected outcome of world economic development and is not, by itself, evidence of a failure in the U.S. The fact that Japan now produces computers and that Brazil now produces airplanes, to choose two examples, is evidence of the remarkable advance in the market economies of the world during the past thirty years.

These achievements impose costs and benefits on us and others. We are forced to change, to become more efficient, to adopt new methods and to develop new products. As we become more efficient, our living standards rise.

Proponents of industrial policy see the world as a mixture of "sunrise" industries and "sunset" industries. This is misleading and sustains the absurd belief that someone "knows" which are the sunrise and which are the sunset industries or that the former should expand and the latter close.

Production of ceramics is one of the oldest industries in the world, but it is currently a growth or "sunrise" industry. Rubber tires production is an old industry, but new technology and new products have produced remarkable changes in the quality of tires, in their safety and in the number of miles travelled per tire. These examples can be expanded almost endlessly. No one can predict when product or process innovations will make a "sunset" industry into a "sunrise" industry or conversely. The great advantage of the market is that it does not concentrate decisions in the hands of experts or community groups but gives opportunity to those who are willing to risk their time, talent and money when making investment decisions.

Public policy has encouraged – and despite some increase in trade barriers, continues to encourage – expansion of world trade and growth in the market economies of the world.

Japan, Taiwan, Korea and others could not have implemented successful policies based on export-led growth, if the U.S. and other countries had not accepted the growth in imports required by these policies. Had we failed to accept their imports, the exporting countries would have been poorer, but we would have been poorer also.

In the two decades following the end of World War II, real per capita income probably increased at a higher rate in more countries and for more people than at any time in recorded history. This progress continued in the seventies, but at a slower rate. We should not abandon the strategy that produced these gains. On the contrary, we should make a concerted effort, to adopt policies that encourage efficiency, enterprise, initiative and policies that remove barriers to world trade and capital movements. We should encourage the rest of the world to do the same.

The Record of Industrial Policy

The typical tract on industrial policy concentrates on Japan and argues that Japan grew rapidly because (1) Japan had MITI and (2) MITI pursued a coordinated industrial policy. Critics of industrial policy typically point to the experience of Britain and the recent experience of France and point to the logical (*post hoc*) fallacy that gives credit to MITI because MITI was there.

Experience in Japan, by itself, tells us nothing about industrial policy. No one should be surprised that some government decisions prove to be insightful, perceptive and correct. It would be surprising if *all* government decisions were wrong or foolish and *all* private decisions correct. If this were true, serious people would not consider industrial policy or government planning and direction of investment.

The comparison of a free market strategy and government planning and directing must be based on the total record, not on specific instances of success or failure. The record of industrial consolidation, state direction of investment in Britain is miserable. Table 1, above, shows that Britain is the only developed country with stagnant or declining industrial production in the seventies. After these policies were reversed, in 1980, productivity growth rose well above the world

average. No doubt some of the increase in U.K. productivity growth is cyclical, but some of the increase is the result of the change in economic policy from industrial policy to a more market oriented policy.

France has recently forced industrial consolidation, the coordination of research and has increased state direction of investment. French governments have always had considerable influence on credit allocation, and government influence has increased. It is too early to reach a final judgment about the results of this experiment with industrial policy, but the early results are not encouraging.

Further, there is the often neglected issue of freedom. Even it could be shown – and I do not believe it can – that on average industrial policy would make a marginal improvement in our real standards of living, we should be unwilling to sacrifice freedom to decide, to spend, to produce, to set wages and prices and to allocate capital. Many countries that have adopted industrial policies – France, the U.K., Japan in the fifties and sixties – imposed controls on capital movements. Formal or informal controls on prices, wages and interest are common where the state imposes its judgment in place of the market. These restrictions on freedom not only reduce allocative efficiency, they restrict the rights of individuals to allocate their incomes and express their individual judgments

Some Suggested Reforms

Much can be done to improve the functioning and performance of the world economy. We should continue to reduce regulation of financial markets, trucking, telecommunications, railroads and other industries. The promising start toward pro-competitive policies has been followed by a slower, more hesitant approach.

Other useful changes should be made to reduce uncertainty about future monetary, fiscal and trade policies. At its recent meeting, the Shadow Open Market Committee recommended

a set of policies that is far more likely to raise real incomes and reduce inflation than any set of proposed industrial policies or other schemes to transfer control of resources from individuals and firms to government agencies. In the following paragraphs, I borrow heavily from the Shadow Committee's September statement.

Monetary Policy

Currently, there is widespread uncertainty about future monetary policy. Will the Federal Reserve be excessively expansive or two contractive? No one can be very certain as long as monetary growth swings over the wide range experienced in recent years and shown in the table.

Quarterly Periods	M1	Monetary Base	Policy
Q4/77-Q4/78	8.2%	9.3%	GO
Q1/79	5.6	7.1	SLOW
Q1/79-Q3/79	10.3	8.6	GO
Q3/79-Q2/80	2.2	7.4	STOP
Q2/80-Q4/80	13.3	9.5	GO
Q4/80-Q2/81	7.1	7.2	SLOW
Q2/81-Q4/81	3.2	4.4	STOP
Q1/82	11.0	10.1	GO
Q1/82-Q3/82	4.7	7.4	SLOW
Q3/82-Q2/83	13.8	10.3	GO
Q3/83-?			SLOW
Averages	7.9	8.0	

Current procedures for monetary policy expose the economy to these continuing risk of alternating periods of excessive monetary expansion followed by excessive monetary contraction. The estimates suggest that the variability of money growth has raised interest rates at all maturities by 1 to 2 percentage points. Lower variability would permit rates to decline and would encourage investment and capital formation and raise the level of income.

The present period of comparable rates of inflation in the major countries offers an opportunity to increase the stability of the world economy, reduce world inflation, and increase the stability of exchange rates and, thus, increase trade and capital investment. These desirable goals can be achieved without fixing exchange rates if principal countries agree to consistent monetary policies.

The governments of the United States, Germany, Japan and the United Kingdom should agree to set the growth rate of the monetary base equal to a moving average rate of growth of real output with adjustment for a moving average growth of base velocity. A policy of this kind would bring relatively stable prices in all countries and would increase the stability of exchange rates. Further, it would provide a disciplined approach that is easily monitored. It would provide targets that even central banks could achieve and would facilitate a gradual adjustment to changes in relative rates of financial intermediation.

Fiscal Policy

Based on current economic forecasts, budget deficits in the range of $175-200 billion can be expected in fiscal years 1984 and 1985. A continuing stream of deficits in this range is likely for the rest of the decade. These deficits reflect the continued high level of government spending. The path of total government spending for the remainder of the decade will be largely determined by spending for defense, pensions (mostly social security), and health care services. Together with interest on the debt, outlays on these programs will account for about 80% of total government spending in the future. Congress and the Administration should reduce the growth rate of real Federal outlays on these programs below the rate of sustainable GNP growth. This would require a re-examination of the defense spending path, and significant structural reforms in retirement and health programs.

Current deficit projections constitute a policy of future *deindustrialization*. Financing the U.S. deficit absorbs savings from the rest of the world. The other side of this capital transfer is an enormous U.S. trade deficit. Business and political leaders conclude wrongly that U.S. goods cannot compete in world markets. They urge protection and industrial policy to slow imports

and subsidies to encourage exports. These recommendations are based on an incorrect diagnosis of the problem. Tariffs, protection and industrial policy will not eliminate the problem but will reduce efficiency and further misallocate resources and lower standards of living. Reversing the current deindustrialization requires reducing government spending. That is the proper solution to the budget deficit and the trade deficit.

Trade Policy

Growing restrictions on international trade in agricultural and manufactured goods reduce opportunities for debtor countries to earn foreign exchange. These restrictions lower standards of living in debtor and creditor countries alike and prevent debtors from earning the resources for investment. Thus, the policies lower output and living standards.

The United States should take the leadership in international economic policy by calling for another round of phased reductions in barriers to capital movements and reductions of quotas, tariffs and other restrictions affecting trade in agricultural and manufactured goods.