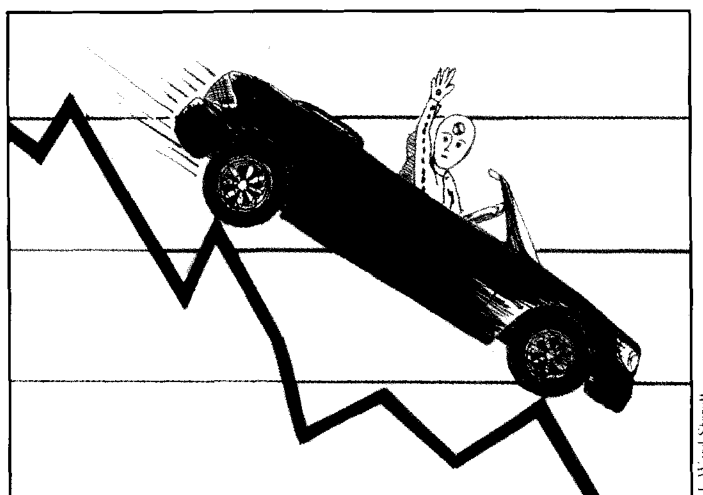
Economic Liberty and American Manufacturing

by Greg Kaza



William Jefferson Clinton mentioned the domestic auto and steel industries a mere seven times in the first two years of his presidency, according to the subject index of his presidential papers. After noting that the auto industry accounted for nearly six percent of the Gross National Product (GNP) in May 1993, President Clinton waited another 17 months before mentioning the sector, which employs more than three million Americans, again. Then he referred to the auto industry five times at the climax of the 1994 campaign. "I listened to them talking about regenerative brakes and fuel cells and ultra-capacitation," he said on October 18, 1994, describing a meeting with auto industry officials and Democratic politicians.

> You know, there wasn't a single one of those things on the three most important cars in my life—my '67 Mustang, my '63 Buick LeSabre, and my '52 Henry J. [Kaiser]. I could fix everything on those cars, except when the hydraulic brakes went out on the Henry J. Then I just shifted down into first gear and ran into the curb.

Unfortunately, the hydraulic brakes, linings, pads, and even rotors have gone out on the so-called New Economy, the greatest financial bubble in American history. This leveraged credit structure escaped its day of reckoning in the fall 1998 Long Term Capital Management scandal, but it continues to damage the manufacturing sector today by artificially increasing demand for dollar-denominated assets. The current downturn, unlike the nine previous postwar recessions, is deflationary, and it may turn out to be the worst downturn since the Great Depression. According to the Federal Reserve Board of Governors, industrial production has declined for 12 consecutive months, the longest contraction since the 1930's. Media pundits, especially neoconservatives, have repeatedly focused on stock-market losses while delegitimizing or ignoring the traumatic changes in auto and steel. Since past industrial downturns have always increased government regulation, the ongoing recession poses political challenges that threaten economic liberty.

One danger is that American workers could lose their faith in a free-enterprise system that has delivered a higher standard of living than most of the world enjoys. If their concerns are deemed illegitimate, workers could vote for a political solution that promises security but delivers more government regulation, economic interventionism, higher taxes, and a lower standard of living. The postwar era has been marked by an understanding that it is in the self-interest of both management and labor in the manufacturing sector to cooperate. That cooperation was based on the premise that the American economy needs a large and prosperous middle class to thrive. This arrangement worked for more than half a century and provided millions of workers and their families with middle-class prosperity. America is still the best place on Earth for workers, the longshoreman philosopher Eric Hoffer observed in *Reflections on the Human Condition*. Hoffer wrote about the wonders of capitalism but warned that the postindustrial age might be as savage as the preindustrial era. Too few on the right have heeded his warning.

President Clinton presided over the longest peacetime economic expansion in U.S. history, yet his papers suggest little experience, practical or theoretical, with the key manufacturing

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sectors of auto or steel. Arkansas ranked 49th among the states in *per capita* income when Mr. Clinton took office as governor in 1979 and remained there, barely ahead of Mississippi, a decade later. His one opportunity to attract an auto manufacturer to Arkansas—Mercedes-Benz—was squandered during his final gubernatorial term. Mr. Clinton stands in great contrast to former president Ronald Reagan, an ex-union leader who understood the regulatory pressures that the manufacturing sector faced.

Mr. Clinton's presidential papers contain only 25 references to the auto industry through December 31, 1999. Ronald Reagan spoke about the industry 65 times. Mr. Clinton had even less interest in domestic steel, which employed 521,000 workers in 1974 but fewer than 150,000 today. He discussed steel only eight times; President Reagan referred to steel on 39 occasions, while John F. Kennedy mentioned it 35 times in his abbreviated presidency.

Mr. Clinton's public remarks reflect this lack of experience. "I think we're going to see a big increase in the number of steel jobs," he predicted on July 26, 1993, "if we have flexibility and competitiveness," control health-care costs, and reduce tariffs. The domestic steel industry, in fact, shed more than 25 percent of its workforce in the 1990's. "You know the steel industry is booming in America today," Mr. Clinton declared on November 4, 1994, "partly because the auto industry is booming in America today." The Kaiser Mr. Clinton drove was built with steel, but the transition to using aluminum and plastics in the auto industry was already well under way in late 1994.

The real economy includes more than the stock market. Even by this yardstick, though, the trends are telling. USX, U.S. Steel's successor and the largest domestic steelmaker, was dropped from the Dow Jones Industrial Average in 1991. Its replacement? Disney. Bethlehem Steel, the second-largest domestic steelmaker, employed 165,000 workers as late as 1957. It was dropped from the Dow in 1997 and declared bankruptcy in October 2001. Nor is Bethlehem an isolated case. Since 1997, 25 American steel firms have filed for bankruptcy, most during Mr. Clinton's second term. Or consider the failed 1998 merger of German automaker Daimler-Benz and Chrysler, the third-largest U.S. automaker. More than $70 billion in market capitalization has been destroyed; the stock has lost more than 60 percent of its value.

President Reagan identified government regulation, such as the Corporate Average Fuel Economy (CAFE) standards, as the source of the auto industry's problems. "The industry must solve its own problems but the government must not unnecessarily hamper its efforts through excessive regulation and interference," he declared in 1981. "This nation has been suffering from regulation that is not within the bounds of reason, regulation that is neither fair nor moderate." In 1984, Mr. Reagan told Michigan UAW workers that "You've demonstrated when the chips are down what people can do working together freely, rather than at the dictates of some central planner or bureaucratic mandate of government." To the chagrin of some libertarians, President Reagan avoided union-bashing. The Teamsters endorsed him, and a new term, Reagan Democrats, was coined to describe his blue-collar supporters in the Midwest. He was the last Republican presidential candidate to win the industrial states of Michigan, Indiana, Wisconsin, Ohio, and Pennsylvania in an election.

The New Economy lauded by President Clinton centers on advanced technology, but it includes a flawed credit structure that makes it very different from the postwar economy, which was based on manufacturing. The American worker once saved at the credit union and bought a modest home or car with a mortgage or auto loan obtained through a community bank. Second mortgages, home-equity loans, car leases, and the subprime market all exploded in the past decade. These are market innovations that mask a reality few on the right are willing to admit: More blue-collar workers are forced to assume debt to maintain a middle-class lifestyle. Real income for working Americans grew from 1946 until the early 1970's, as such industrial giants as General Motors, Ford, and U.S. Steel created millions of jobs and widespread middle-class prosperity. AFL-CIO leader George Meany declared in 1955 that "American labor has never had it so good." Average weekly earnings of manufacturing workers increased 20 percent from 1953 to 1956, while inflation grew less than one percent under President Dwight D. Eisenhower.

By contrast, the New Economy is based on an ability of the credit structure to extend debt and leverage that would have been unimaginable a generation ago. In many respects, American manufacturing families of the 1950's and 1960's were more prosperous than their counterparts today, who save less and are more leveraged than at any time in the postwar era. The credit structure, including such government-sponsored enterprises as Fannie Mae and Freddie Mac, artificially increases demand for homes, mortgages, and refinancings. The derivatives employed by the country's largest financial institutions go beyond hedging risk (a legitimate purpose) to artificially expand credit for speculation. Manufacturing has collapsed as global demand for more U.S. dollars and dollar-denominated assets has risen. These financial institutions, considered "too big to fail," increase liquidity demands on the Federal Reserve in times of crisis. Few on the right understand these changes to the credit structure, let alone their impact on manufacturing.

Federal Reserve Board Chairman Alan Greenspan, in a December 5, 1996, speech widely criticized by neoconservatives and libertarians, warned about the implications of rising asset values. Mr. Greenspan asked, "But how do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions as they have in Japan over the past decade?" Central bankers, Mr. Greenspan said, "need not be concerned if a collapsing financial asset bubble does not threaten to impair the real economy, its production, jobs, and price stability . . . But we should not underestimate or become complacent about the complexity of the interactions of asset markets and the economy."

Five years later, Mr. Greenspan's remarks seem remarkably prescient. Asset prices (equities and real estate) have continued to collapse in Japan; for the fourth time in a decade, the world's second-largest economy is in recession. From a peak of 38,915 in December 1989, the Nikkei 225 has declined nearly 75 percent, a decline comparable to the 65-percent drop in the tech-heavy NASDAQ since March 10, 2000. By any historical standard, the NASDAQ was trading at speculative valuations. The P/E ratio, which compares a company's stock price to its earnings, is a staple of securities analysis. In March 2000, the NASDAQ was trading at an astronomical 264 times earnings. Consider another fact: Twenty NASDAQ 100 firms had no earnings in summer 1999. That number grew to 30 in 2000 and 40 last summer. These are signs of speculative weakness, not funda-

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mental strength.

The United States is about to learn the answer to the second question raised by Chairman Greenspan: Do falling asset values impair real economy sectors such as manufacturing? President Clinton did not think so, declaring as he left office that the economy "remains strong . . . the response will continue." At the time, industrial production, an indicator used by the National Bureau of Economic Research to determine whether the economy is in recession, had already fallen four consecutive months. Today, industrial production has contracted for more than a year. Neoconservatives have said little about manufacturing's decline before or after the horrific September 11 terrorist attacks. They share Bill Clinton's notion that rising stock-market indexes and a burgeoning domestic service sector indicate a strong real economy.

The collapse of domestic stock-market indexes caught many on the political right by surprise. For years, they discounted fundamental securities analysis as too "old-fashioned" or "traditional." Few heeded older, wiser, and saner voices. "The fate of the world economy," ex-Fed Chairman Paul Volcker said in 1999, "is now totally dependent on the growth of the U.S. economy, which is dependent on the stock market, whose growth is dependent on about 50 stocks, half of which have never reported any earnings." New Economy advocates argue that rich equity valuations are justified. Stock prices rise and consumer spending (two thirds of GNP) increases when individuals feel "wealthier." But wealth effects based on the new metrics described by Mr. Volcker inevitably revert to their historic norms in recession.

New Economy supporters have argued that the business cycle has been repealed. The recession has ended that argument. The cycle is real; the Austrian School of Economics developed an explanation for its occurrence back in the 1920's. Octogenarian neo-Austrian Dr. Kurt Richebacher, former chief economist and managing partner at Germany's Dresdner Bank, warned in the late 1990's that all four elements of a bubble were present: money and credit expansion in excess of savings and GNP growth; inflationary pressures pushed into the future in asset prices; loose monetary policy; and excessive and unsustainable borrowing against soaring asset prices.

Those neoconservatives who discounted the business cycle and, therefore, suffered market losses from unwise choices have found a scapegoat: Alan Greenspan. Fox TV entertainer Bill O'Reilly, for example, blamed the recession on Mr. Greenspan's failure to cut interest rates in late 2000. "[T]he economic dam broke," he wrote, "and the waters of declining earnings flooded the stock market" (*www.WorldNetDaily.com*, May 10, 2001). In reality, the Fed eased in 1998 in response to the Long-Term Capital Management scandal, eased again in 1999 before Y2K, and tightened in 2000 to mop up. The NASDAQ, the Dow Jones Industrial Average, and the S&P 500 all started their plunge into bear-market territory in early, not late, 2000.

National Review has been vociferous in its criticism of Mr. Greenspan. The broad money supply (M3) grew at a blistering 13 percent rate through late October; Money of Zero Maturity (which includes currency, checking accounts, and money-market funds), grew at a high of 32 percent annualized post-September 11. The Fed has cut the intended discount rate from 6.5 percent to two percent this year. Yet NR accuses Mr. Greenspan of not inflating the money supply enough! The Fed cannot pump up the stock prices of firms with no earnings by increasing money-supply growth indefinitely. At some point, perhaps soon, the discount rate may near one percent.

Manufacturing workers have known for decades that the Fed is not omnipotent. The Fed added to the Great Depression by contracting the money supply; under Chairman Arthur Burns, it generated the double-digit inflation of the 1970's, which Mr. Volcker later cleaned up. Both periods produced great hardships for domestic auto and steel workers, who learned to plan for the inevitable recession. Today, there is an even greater need to explain the credit structure's shortcomings.

Long-Term Capital Management remains the best example of the new structure's failure, although the Mexican financial bailout of 1994 and the Asian currency crisis of 1997 are also good examples. When LTCM collapsed in the fall of 1998, it nearly took with it the largest New York financial institutions and European central banks, which had imprudently extended it excess credit. The leverage used by LTCM, greater than 20 to one on some trades, was employed to purchase derivatives that would increase in value if bond yield spreads reverted to historical norms. Instead, they increased after Russia's fall 1998 default and ruble devaluation. LTCM also bet the wrong way on merger arbitrage deals involving telecom firms like Ciena and Tellabs. Total losses were more than two billion dollars, but LTCM's real exposure was estimated at more than $40 billion, based on its derivatives book. The New York Fed brokered a controversial bailout, suggesting that "too big to fail" is more real than some libertarians ever imagined.

LTCM's customers, if not their finance professors, learned a bitter lesson that libertarians should consider: Derivatives can insure individual market participants against risk, but not the entire credit structure. Reliance on them is a sign of weakness, not strength. The LTCM bailout was corporate welfare at its very worst.

Arkansas politicians are fond of comparing their state favorably to Mississippi. No matter how bad conditions are in Arkansas, it is said that they are worse across Big Muddy. Governor Clinton never successfully pursued the goal of an auto plant, with its thousands of high-paying jobs, in Arkansas. Mercedes-Benz chose Alabama. But Mississippi, the last of six states bordering Arkansas to land an auto manufacturer, convinced Nissan to build a factory near Jackson. General Motors has plants in Texas, Oklahoma, Missouri, and Louisiana, and Saturn is considering a second plant in Tennessee. Mr. Clinton's legacy in Arkansas did not include high-paying manufacturing jobs for the middle class. Forty-nine percent of Arkansans today earn less than $21,000 annually. It would be unwise to pursue this legacy in other states.

Nor would it be prudent to overregulate manufacturing while extending the market-distorting credit structure with its insatiable appetite for debt and liquidity. The structure faced crises in 1994, 1997, and 1998. It is unstable; another crisis is inevitable. Conservatives understand that there cannot be political freedom without economic liberty; entrepreneurs must be free to take risks and profit from them. But they must also care about their workers and suffer their losses without seeking corporate welfare and special privileges from government. A market-distorting credit structure that rewards financial institutions with bailouts in times of crisis is not a paragon of free enterprise. It undermines both economic liberty and the family, which is the chief bulwark against an intrusive government.

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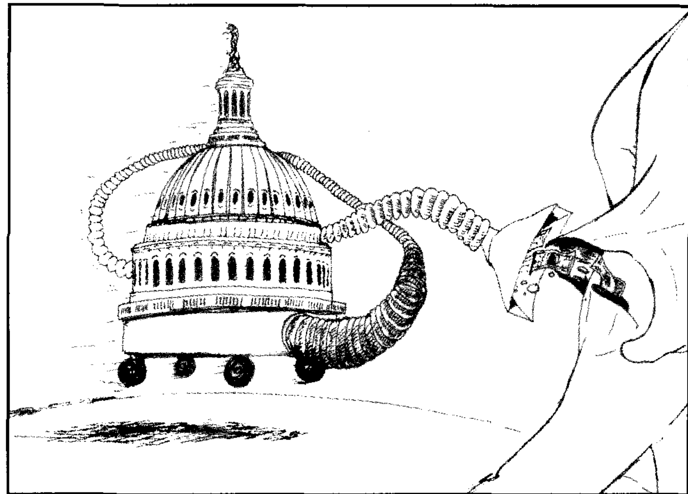
Diseconomies of Scale

Dismembering Leviathan

by Donald W. Livingston


H. Ward Sterett

"Free trade," like "free love," is a beguiling abstraction that hides more than it reveals. Absolute free trade would be an exchange of commodities between two people without the coercive intervention of a third party. But economic exchange is always embedded in a cultural landscape of noneconomic values, which impose restraints. Blue laws prevent trade on Sundays, medieval Christendom prohibited charging interest on money, and some think no decent society could legalize the sale of drugs or firearms. If someone disagrees with these restraints, it is because he rejects the *moral* ideals they express, not because he favors "free trade." Within the restrictions imposed by usury laws, trade flourished in medieval Europe; indeed, it gave rise to the practices we call "capitalism" today. Those who value liberty may seek to minimize these constraints, but economic relations cannot exist outside of noneconomic restraints.

The failure to understand this leads to a number of modern superstitions. One is the illusion that there are economic experts in the way there are experts in medicine or chemistry. But economics is not a predictive science, because it does not have deterministic laws. We act on the basis of our knowledge, and no one can predict future knowledge (to do so would be already to possess it), much less predict how people would react to this knowledge. No one, for example, predicted the stagflation of the late 1970's. So-called economic laws hold only as long as the shared noneconomic restraints obtain. The "iron law" of economics—that there cannot be full employment and low inflation—does not hold if, like the Romans, you are willing to live by tribute.

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Adam Smith correctly observed that it is from the self-interest of the butcher, baker, and brewer that we expect our dinner, not from their benevolence. Friedrich Hayek won a Nobel prize by refining Smith's argument to demonstrate that the planned economies of socialist and communist countries were doomed to failure because no central agency could ever possess the knowledge needed to achieve what a market can accomplish without planning. This solid insight into a part of social experience would be transmuted by some into a doctrine of the whole: the ideology of *laissez-faire* capitalism. As Michael Oakeshott observed, Hayek's plan to prevent planning is perhaps better than socialism, but it is still a centralized plan that could and did collapse into another modern superstition.

To understand this, we should ask a question that Hayek failed to ask: How did communist and national-socialist regimes come to be? They emerged out of a Europe whose social order had been shattered by World War I, a war that was largely the work of liberal regimes. Milton Friedman and others have praised the period from the Congress of Vienna in 1814 to 1914 as the century of *laissez faire* and, consequently, as the century with less war than any other in modern European history. But it was also the century of wars of unification and centralization, in which smaller political societies of all kinds were crushed into vast states. This period was a century of relative peace only if the concept of war is limited to conflicts between large-scale nation-states. But if we consider the wars of unification in Germany, Italy, the Brazilian war to suppress the secession of Sao Paulo, the American war to suppress the secession of the Southern states (the bloodiest war since the Thirty Years' War), and similar wars of unification elsewhere—not to mention global imperialism—we must conclude that it was one of the most violent centuries in European history.

The vast territorial states created by this runaway disposition to centralize justified themselves by claiming that they had

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