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Economic Dynamics – Analysis and Policy

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Introduction

In the Autumn of 1994, it appeared to me that Portugal had reached a point in the social, cultural and economic development of the country where decisions needed to be taken about the future direction which its society should aim. Very regrettably, a certain lack of flexibility within the government meant that the country was allowed to drift along the same course. Farming, fishing and industrial developments simply continued to be sacrificed on the altar of the European Community, so that various funds could be secured from Brussels in order to balance off the country's external trade and internal budget deficits.

Whether the country progresses within the opportunities afforded to it through its relations with the nations of the Mahgreb, with Angola, Mozambique and other Portuguese-speaking African nations, as well as by virtue of its membership of the European Union, will now depend greatly on decisions yet to be taken by the recently elected government. There is, however resentful one may feel about it, very little useful objective to be gained by discussing the desirability of being in the European Community. The country is in it, probably would have a very difficult time if it were not and, therefore, needs to make the best of the possibilities that membership will offer.

At the same time, it is assuredly necessary for a review of what the aims of Portuguese society really are. The consensus with which the new Prime Minister wishes to work has yet to be established. Only 68% of the

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electorate voted, while 32% abstained. It appears that there is a distinct lack of clarity about the social, cultural, ethical and moral values to which the population wishes to adhere. And until these are identified and asserted, political leadership can only operate on a day to day ad hoc basis.

This article is an attempt to review some of the choices of policy which the country could make. And, although it is broadly concerned with the dynamization of the economy, I hope that it will be found to be as closely related to the interests of people in business, commerce, industry and public service as it may be to academic economists. My viewpoint is that of a specialist in business management who has been involved in the world of finance for well over thirty years. At the same time, I have studied economic matters deeply, always believing that economic policy is of absolutely prime interest to business managers, as well as governments, and probably far too important to be left to politicians and their economic advisors alone.

Economic Dynamics

Let me begin by stipulating one basic term of reference as underlying all that I suggest: *Economic policy is a struggle to find one's way through chaos to a desired objective.* If this is accepted, then what we see as controversial analyses can provide sound foundations for our thinking. To uncover these analyses, perhaps we may resort to Edward de Bono's lateral thinking approach, whereby we ask "what if the accepted wisdom is fundamentally unsound?" But first let me present to you a number of points about the situation affecting the world economy as a whole. Then, if we look at a few examples, perhaps we may draw conclusions about parallel situations closer to home.

To many people economic dynamism has come to be equated with the exploitation of innovative technologies, leading to spontaneous economic growth within a free market economy. I shall refer to it as such and that it implies open competition free from centralist interference. I also think that, in today's increasingly global markets, this means that the outcome of such competition is likely to be impossible to project with any degree of assurance. I say 'likely to be', because ever more countries are catching up in the races for technological advantage and this trend to genuinely world-wide competition must imply that there is little chance of anyone being able to foresee who will be the winners. Such competition may nonetheless lead to further growth prospects for all the countries involved.

This competition also needs to be open to innovation both by a country's own nationals and by foreigners furnishing both human and financial capital, provided that their participation does not undermine economically efficient cultural values. Because, unless foreigners are ready to help preserve a nation's ethics and mores, they will always be looked upon with suspicion or resentment. This does not imply any need to preserve or instigate regulations which restrain initiatives. Dynamic competition can only be accelerated by the removal of such restraints, and the envy of gains earned by foreigners has to be converted into motivation: a) to catch up with neighboring countries and b) to make other kinds of investments in those countries, thus cementing the trade and, eventually, cultural ties between them.

The population also has to be shown how it can expect positive benefits when others, through their enterprise, are enriching the local community. Perhaps through programs on television, the point can be brought home: those who are successful in generating profitable enterprises not only provide employment but also create demand for supplies from other enterprises, *at the same time as* they initiate the multiplying factor that results from the payment of wages. Education of this kind can change attitudes to an astonishing degree.

People quickly realize that they can indeed play a part in a positive way in the development of their community, adding their own cooperative efforts and productivity to those of the entrepreneurs who start the game going. The result is a progressive social atmosphere. Instead of engaging in confrontational demands for larger and larger slices of the revenue cake, the workforce as a whole becomes, and remains, anxious to maintain the successes of industry and commerce through the achievement of consensus with management. Strong evidence of this was provided both in West Germany and in Japan during their reconstruction years.

At the same time, a particularly important point needs to be recognized by governments of all political shades. Winners have to be encouraged, not treated as milch cows for wasteful public expenditures. They need to be allowed to keep at least 70% of their entrepreneurial profits for their own purposes, if necessary through tax exemptions for reinvestments into expansion, modernization and further innovative enterprise. Otherwise, if the tax bite is too high, the game will not be worth the risks, and capital will be diverted to gaining guaranteed high interest returns from the bonds that the government concerned has to sell in order to make up for low tax revenues.

Attempts to redistribute wealth through taxation are always self-defeating. They cause the amount of wealth creation to diminish. As a result, there is less available for everybody, including the ever hungry public sector. People have to be free to exploit their own talents, *always provided that this does not imply their trampling on the freedom of others to fend for themselves at the same time.* This means that those individuals who have more talent, including the abilities required for planning, organization and budgetary control, will inevitably be more successful than the others. But this has to happen, if others, who lack the necessary amounts of talent or entrepreneurial spirit, are to be provided with gainful employment. The only system which will tend to reduce such inequalities is the cooperative one, because it allows for the less talented to receive greater shares of the wealth generated by the enterprise in which they work than they would in a privately held company or corporation. But such enterprises exist only by virtue of common consent to contribute individual talents and share overall risks and rewards, through differentiated salaries but equal amounts of the bonus distributions that are warranted, after necessary allocations for reserves and reinvestment.

Economic dynamism depends on the increased availability of credit for innovative enterprise. This remains as true today as when it was first propounded by Schumpeter. It also depends on two other factors: the formation of human capital and the growth of knowledge. One of my principal propositions is that there has to be conscientious effort to institute and maintain a financial system which creates incentives that will lead to the development of these three factors on a systematic and continuous basis, if there is to be adequate acceleration of economic growth to head off the mounting difficulties posed by poverty, hunger, ignorance and disease (P.H.I.D.). The experience of country after country has demonstrated adequately enough for all to see that the amount of dynamism within a country varies inversely with the prevalent levels of key interest rates. Consequently, the containment of these levels needs to be kept within reasonable bounds or, stated in another way, so that *real* interest rates shall not exceed 3%. In Europe, this would automatically imply a coordination of real interest rates which would take account of the different rates of inflation being experienced by each nation. Naturally, convergence would remain a continuing goal.*

* I put my case in favor of such international Coordination in a paper entitled "Development and a 3% Base Deposit Rate" (1995).

If the coordination were to be achieved, it would eliminate the pressure for a single currency for the European Union, whilst preserving both the cohesion of a single market and the subsidiarity of decisions regarding rates of inflation which different countries and/or regions of the union need to make in line with their varying circumstances.

Dynamic competition is a process of discovery (Hayek) and it enables us to open up new frontiers of knowledge. The future will show which new knowledge is in fact useful and which technologies will quickly become obsolete. We have to be ready to welcome this winnowing process, if we wish to realize our full potential for economic development. This implies encouraging research, while conserving those national cultural values which are needed to maintain the nation's psychological balance. Optimism about the future is more than welcome but it has to be tempered with the desire to hold on to enough of what has lasting value to preserve a stable, yet forward-looking, society. Hope and the wish to create a better world is not the same as 'damn the torpedoes, full speed ahead'.

According to Herbert Giersch, the outcome of dynamic competition may often be the form of cooperation-operation which evolves within the pattern of a deepening division of labor. People want to make use of their comparative advantages, once they have discovered their relative strengths and weaknesses. They want to specialize and increase their own particular knowledge and expertise. They are likely to pursue the path of learning by doing. This means that they will require to develop complementary roles with others in their own enterprises as well as with suppliers and customers. This implies cooperation all along the line.

Cooperation within whole industries is simply an extension of cooperation within one enterprise. The aim is to create a strong base within a competitive world, from which each person or company may realize better results, leading to a better quality of life all round. Cooperation tends to centralize many operations, enabling reductions in costs in catering for wider markets. It also generates lower purchasing costs and improves efficiency. All, if it be truly recognized, to enable the otherwise disadvantaged to compete with the big giants. So with individuals, with companies, with regional industries and, what is all too often forgotten, with nations. As can readily be seen within the emerging European Union. Competitive pressure is constantly bearing down on national governments, and through them onto regional and local authorities in their dealings with industry, agriculture, viniculture and fisheries. Many civil servants are going to have to be retrained, whilst many others study business management, if the civil service is going to be able to furnish their communities with the required support and understanding.

In Europe we are only seeing the beginnings of a continent-wide increase in the mobility of human and financial capital. Add to this the vast speed at which knowledge can be spread as a result of the communications revolution, and we see that the nations making up the European Union have no alternative but to cooperate, if they are to compete in what is already a global market for goods, services, information and, of course, finance. Meanwhile, the creation of the great information networks means that there are millions more people with ideas and talent who can be sought out by the centres of research and managerial headhunters. The rate of growth of knowledge is already accelerating by leaps and bounds. As more and more countries become integrated into the global economy the greater will be the pace of the rate of change.

This, beyond the least shadow of doubt, will double, triple or even quadruple the amount of innovation and its consequent demand for credit. The upward pressure on real interest rates would present a problem, unless at the same time what in Britain is called the Public Sector Borrowing Requirement (P.S.B.R.) is drastically reduced. Two things saved the British Economy during Margaret Thatcher's regime: North Sea Oil and her determination to eliminate the huge burden posed on the economy by public sector spending. In Portugal, to outside, impartial, observers, this burden would appear to be unacceptably high to any government, whether it be red, pink, orange, green or blue, as soon as they reflect that perhaps one third of the workforce is employed within the public sector, and even more if those who work for local authorities are included. Whereas, for the economy to have a fair chance of becoming competitive with the Northern European countries, most analysts will agree that the target level should be closer to 30%. It is true that Italy and Greece have at least as big a problem with the stranglehold that their public sectors pose to their economies, but, although troubles shared may make their burden seem easier to carry , does this give any real grounds for satisfaction?

What would I recommend?

Firstly, faster paced privatization, and, secondly, the reduction of the number of civil servants through attrition, while the only new entrants to be recruited would be those who have the necessary talent and qualifications to raise public sector productivity as well as improve the quality of essential services. Meanwhile, the large state-owned enterprises should be re-engineered and encouraged to develop innovative subsidiaries. These could then be sold to those who make them successful via management buyouts.

Privatization of the nuclei should be speeded up, with the treasury writing off their debt burdens and restructuring their workforces, as was done, for instance, in the case of British Airways. The cost to the treasury would be far less than maintaining the enterprises as they are, *absorbing their annual losses*, and hoping to obtain high prices in public offerings of their shares at a later juncture. More importantly, it would get the economy moving faster and much sooner.

There is also a human problem which cannot be ignored: the problem of caring and catering for the number of people made redundant by re-engineering and restructuring, including those who were employed at managerial levels. I would suggest that they be retrained with modern skills, so that they can make their contributions and *earn* their livings within all the new innovative enterprises that will be springing up all around them, in whatever part of the country they live. Let us make no mistake. As a result of the communications revolution, there will be businesses starting up and developing everywhere, breathing new life into provincial communities and the regions which encourage them with special conditions.

One thing is certain, global dynamism will increase inequalities whatever the state of the national economy concerned. In addition, wage rates are likely to be low while the abundance of labor available is being absorbed into the new enterprises. Entrepreneurs and skilled workers find greater opportunities for building their lives, but the wages for unskilled workers is bound to decrease in line with the lack of demand for their type of labor. There may have to be a certain amount of trade-off between equality and development. But this would surely be better than having ever-increasing numbers of the long-term unemployed whom technology will have displaced from their unproductive posts in manufacturing industries. Wages in Europe as a whole will have to be tied to added productivity of the new kinds of goods and, particularly, services. Here again, it is business management courses and other types of retraining which will provide the key to absorbing the pool of structurally redundant people.

It is interesting to note two very disparate examples of how reforming an economy does not have to mean vast increases in the numbers of long-term unemployed people. In Poland, small entrepreneurs responded very successfully to the enormous challenges posed to them by the shock treatment applied to their economy. This resulted in an extraordinarily wide-spread change from a centrally run economy to an entrepreneurial one, characterized by an excellent ability to produce new jobs. This can be compared only, perhaps, to the growth of the number of jobs created in the U.S.A., in spite of reductions in the public sector, between 1965 and 1985.*

Wage rates will always find their own level, as determined by the market. Governments should keep out of the process. They only make matters worse, except when getting their own employees to recognize that wage increases can only be accompanied by restructuring and increased levels of productivity. (By increased levels of public service productivity, I mean the same people accomplishing more within their own spheres of work.) What Governments should do, expressly, is cooperate with the private sector by restricting the public sector's demands for finance. Public Sector Activities should be financed out of revenues: *revenues which are developed as the result of constant, steady growth of enterprise and employment in the private sector.*

As I said earlier, one of my principal propositions is that there has to be a conscientious effort to institute and maintain a financial system which

* Jan Bielecki, Polish Prime Minister from Jan-Dec 1991 and currently a member of the board of the European Bank for Reconstruction and Development in London, Wall Street Journal, 17 Nov, 1994.

creates incentives for enterprise. This implies enabling the capital market to trade in credit for the purpose of financing development. Note that 'for economic development to take place it has to be both growth-inducing and growth-sustaining, so that changes in the industrial structure will yield higher productivity and higher real average income per working person' (Firestone, 1969). But, for this to be achieved on a steady basis, monetary policies have to be geared to enable the provision of credit at interest rates which will vary only within narrow limits.

My research shows me that in the last fifty years the key to bursts of economic development in various western countries was not the low cost of labor but the low cost of abundant liquidity. It has also shown me that as soon as a national deficit grows, either internally or in external trade, the government of the country is forced to pay more and more for its borrowing, fueling cost-push stagflation as though stoking a furnace. Perhaps, therefore, we may stress the point that dynamism depends absolutely on the availability of cheap credit. Because this is where socialist governments have previously gone wrong. They were unable to recognize that competing with the private sector for funds, so as to finance public sector deficit spending, is sure to put the brakes on any expansion. Rather than public spending helping to advance the economy, it does the reverse, when it entails a budgetary deficit.

Keynes' main aim, when he produced his *The General Theory of Employment, Interest and Money*, was to lay the groundwork for intervention by governments to manage demand, chiefly by fiscal means. Thus, he maintained, expenditures within the economy could be influenced sufficiently to maintain high levels of output and, therefore, employment. There are no grounds for believing that deficit spending on public works can in any way substitute for his approach. Make work projects are desperate measures, always very short term in effect, and have no lasting positive effect on economic growth or development.

This automatically raises the question as to what shall be done about exchange rates, when a country is determined to catch up with the developed state of its neighbors. In my opinion, that country should not allow its currency to be overvalued to the extent that its domestic exporters of traditional goods are handicapped in the competition for a share of expanding world markets. If you question whether they are expanding, think not only of the integration of the European markets but, even more significantly, of South-East Asia and China. If, in the meantime, the undervaluation of the currency implies imports of capital and deficits in the balance of payments on current account, remain conscious that this capital inflow is desirable, so that the increases of production necessary to the fast growth of the exports can be adequately financed. The judgment has to be made on the basis of whether the deficit will remain small enough in relation to the rate of growth of exports so as not to represent a fundamental disequilibrium. As long as there will be fast export growth, the inflows of funds will be being channeled into increasing export capacity rather than into domestic consumption.

For the present, I believe that stubborn insistence on convergence criteria in order to enable the creation of the single 'Euro' currency by 1999 is a big mistake. However desirable a single currency might be in the long run, the current trade-off costs are too high in terms of the dislocation of national economies and their growing rates of unemployment. The free working of the foreign exchange markets within a modified version of the E.M.S. should be allowed to function until there is a greater degree of equalization between the economies of the member states. The modification that I would propose is that of the voluntary coordination of *real* interest rates at, say, a 3% level. If an agreement to do this could be carried out, a good portion of destabilizing money flows between the member countries would be eliminated.

Then, and then only, in my opinion, would the creation of a single currency become viable. In the meantime, the individual governments need the time to put their fiscal houses in order without creating conditions which can only lead to social disruption, disorder and potentially violent protest. The date for the creation of a single currency should not be a sacred cow. Nor should fudging and stretching convergence criteria be an acceptable way forward. Provided that the social needs of Europe's various peoples are given priority, the at present considerably justifiable opposition to the 'Euro' would diminish. The argument that if things aren't implemented in 1999 they never will be just doesn't hold water. New opportunities for human endeavor always arise. And, if what is then created differs from what was originally envisaged, it usually turns out to have better foundations.

Some economists still argue for substantial devaluations, on the grounds that they enhance exports and inhibit certain consumer imports. I disagree, even though Britain's experience in this respect, when it left the European Monetary System, was temporarily beneficial and reinforced doubts as to whether the idea of a unified currency is a good one, when considering the disparity between the development patterns of the nations to be involved. But it does seem to strengthen my argument that only after a reasonable convergence of interest rates, inflationary pressures and levels of taxation have already been achieved will the setting of a date for a single currency be viable. Nevertheless, I tend to believe that large devaluations for short-term trading advantage seldom have the hoped for lasting effect. Free trade competition has to be met squarely, by increased efficiency and the reengineering of the way in which both the public sector and private enterprises are run.

It was Schumpeter's view that any policy application has to allow for the unique historic situation in which it is to be applied. Affected as we are by the information revolution, modern economic situations are not only unique but constantly taking on a new twist. We may well look on them as chaotic The speed at which of networking enables us to have an ever growing amount of knowledge within our grasp means that little is to be gained from statistics which are obsolescent even as they are being produced. For us, perhaps, structural change is replacing growth as the central field of economic dynamics. Of course, structural change does generate growth but it tends to hurt almost as large a proportion of the population as it benefits. Policies will have to be developed to change the ways in which those adversely affected can obtain their share of gross national income.

Meanwhile, the trade-off is going to be between development and security. Because redistribution of incomes has been shown to have the effect of choking off progress, policy-makers will have to find better answers. They will need the help of concentrated sociological and economic research, which aims at being more than mere analysis and will point to ways to achieve desired results. This, I submit, will need contributions from many individuals and, probably, less committees. Perhaps then, together, we may engender that stable growth of low-cost financial resources which will allow humanity to use of growth of knowledge along paths and to degrees of which mankind has so far only dreamed.

Keywords: Downsizing, Re-engineering, Restructuring, Retraining.

Downsizing: A euphemism for cutting down the number of jobs within an organization.

Re-engineering (A concept promoted by and large by Michael Hammer): The radical redesign of a company's business processes, reinventing the way the enterprise operates in order to meet the requirements of a continually changing market within a modern economy. This has nothing to do with eliminating jobs. Rather it has to do with devising different methods of operation. It does this through the creation and cultivation of innovative strategies. By significantly improving the operating capabilities of an enterprise, it enables it not only to implement new strategies but, perhaps more importantly, to envision new strategic options.

The shaping of new strategy, based on operating processes, rather than products and markets, means that newly created strengths in operating processes can be exploited in many ways. It can be designed to provide cost advantages or improved customer service. It can open up new markets for existing products, identify new ways of using existing skills, or make it possible to start up entirely new lines of business by, for instance, turning internal processes into services which can be sold.

Restructuring: Changing which department of an enterprise does what and with what objectives in view, eliminating some departments and staff levels which do not make a positive contribution to the overall profitability of the enterprise.

Retraining: Teaching people entirely new skills, which are of value in the new markets for labor, when their previously acquired skills are no longer in demand and can no longer be sold to an employer in return for a living wage.

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