

Transitioning between economies

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If we go back a few hundred years prior to the industrial revolution, most countries in the world had what is referred to as an agrarian economy. The central principles of this is that the majority of capital is allocated towards activities linked to agricultural production. The result of this is a largely decentralized population, because people tend to live where it was possible to grow food, while supply-chains were not efficient enough and we lacked the technology to preserve food during transport.

This is the situation that much of the world is still in, people live on small, rural and family owned farms. Mixed crop production is still common, as people try to have production of their own staples, and the production is largely done by traditional methods.

Sure, goods that are not food are still produced, but at a smaller and much more local scale in such an economy. There are factories, but they tend to be small, and work largely off collectives or guilds of artisans.

The industrial revolution provided manufacturing jobs on a scale not seen before, and the capital made its transition away from agriculture and country estates to real estate in cities and manufacturing plants. This enabled us to produce both a higher quality and quantity of goods through specialization. This brings something referred to as “economies of scale” into the mix, which is basically that the cost of production drops with additional units as fixed costs are distributed across an increasing number of units.

Combined with higher levels of specialization, meaning that people get really good at one thing, rather than having to be passable at 4 or 5 things, means that production efficiency goes up, which means a higher production at less inputs. This continued to happen throughout the 19th and 20th century where manufacturing slowly became the giant industry that was the engine of the economies of the United States and most of Western Europe. You make stuff in your country and sell it both in your own country and to trading partners internationally. As long as you had a largely domestic production, you got jobs and good standards of living for your citizens. You get a nice import-export balance, and a nice boost to GDP every year. As communications improved and you could export more and more goods, someone had a bright idea that if wages are lower outside of your country, and most of your market is inside your country, you could in theory produce in lets say Asia, then ship and import the goods into your own country to sell

them there.

This would bring down cost, while maintaining margins, resulting in a higher return on capital invested. This efficiency bug bit into most of manufacturing starting with Taylorism and still going strong today with consulting companies ready to “*Pimp your Profits*” with the latest and greatest in buzzwords and PowerPoint presentations.

All the while this was going on and we were slowly making the transition from a mostly local, then regional, then national and then finally international economy, someone theorized that if you reduced tax burden on the wealthiest citizens, it followed that their tax savings would go towards investing in more business to make even more money. This follows fairly logically from the 3 things you can do with money, save, spend or invest. The wealthy tend to spend less of their income as a percentage than the less wealthy, they tend to know that savings accounts are the worst place to put your money and as they are wealthy they have a proven track-record of earning good returns on capital.

This logic is sound, but as we had also made the transition from a mostly national economy, where fair enough regional variances played into where you would build your factory, but it benefited the country giving the tax cut. We were now living in a global economy, where national circumstances still played a part, but where the options for where to invest were much greater. For instance, a U.S tycoon who would have picked starting a factory in Mississippi in 1960, could now establish his factory in Guandong province in China, or in Malaysia or Vietnam, and actually save money when the books were done.

Now, most people when they think about it logically, understand that if it is cheaper to make something in China, then ship it to America by long-haul and container ship, something has to be a little wrong. People understand that if they go into their kitchen and make a sandwich, that sandwich will be cheaper than if they drive to a cafe down the street and buy it.

The reason was a mixture of scale economies in shipping, production, government incentives in the US and China, scale of production, low wages, and a host of other things. However, this wouldn't have been a problem if the Western world had understood the basics of Adam Smith, that some countries develop competitive advantages and that these change over time.

When this happens, you can either try to impose tariffs or other forms of barriers to secure domestic jobs, or you can adapt to the changes and get ahead of them. This was unfortunately what the West failed to do.

The knowledge economy and the service economy are both the suggested replacements for the manufacturing sector that is being lost to countries where higher ROI is earned in manufacturing. We can discuss why the ROI is better in those countries, which are things ranging from failing to deal with externalities, asymmetric subsidies/programs/incentives, bad trade deals, lower wages, and a range of other things. Or we can do the rational thing in my mind, which is to look at the road forward.

When the west transitioned from the agrarian economy to the industrial economy, there were robberbarons, and horrible working conditions, people thought all humans would be replaced by machines, and a range of other things. The core problem with losing the manufacturing sector, is that there was nothing to replace the myriad of low-skilled jobs available to what is the major part of the population.

I could argue this in multiple ways, but the easiest way to put it, is that the industrial revolution, followed by the green revolution and advances in medicine lead to a drastic population increase, which meant more jobs were needed, and those jobs were found in manufacturing. There are simply too many people competing for the same manufacturing and service jobs, on a global scale. To borrow one part of Michael Porter's 5 forces, the barriers to entry are very low for manufacturing jobs.

Service jobs are also have somewhat low entry barriers, however the trouble with service jobs is that they

do require something that most factory jobs do not, namely people skills. Few people really care who produces the things they want to buy, hence the high amount of people tweeting to raise the minimum wage and that everyone deserves good working conditions on an iPhone. However, people do not tend to like their waiter to be impolite, brash, or a host of other things that do not cause problems if you work an assembly line.

Then comes the knowledge economy, the next leap forward where human knowledge, lead by the STEM fields are set to become the focal point for the next 100 years or so. Yet, we lack STEM graduates, we lack people with basic scientific knowledge, despite having the World's best universities in the west, we have a population that are not equipped to take the next step into knowledge production. We also have states that are living in the manufacturing bubble, with tax systems, regulations and laws that are not adapted to things like the software industry, biotechnology or many of the new frontiers. Only, unlike the transition from the agrarian period to the industrial period, where regulations, laws, enforcements, incentives and international trade did not exist. We now have regulations, laws, enforcements, incentives and international trade that is not adapted to the future. Where the industrial revolution had plentiful labor as it required no-skilled labor, that even children could do. The knowledge economy requires a highly skilled population with a level of education that may be unattainable for the vast majority of people. Knowledge economy jobs have much higher barriers to entry than manufacturing or service jobs.

This indicates that the transition from manufacturing/service economy, to knowledge and technology economy may be a brutal transition for the West. The late bloomers to the party such as the BRIC countries still have a lot of manufacturing demand from their own countries, whereas western countries largely import their goods from other countries in the name of cheap and efficient. This could play out a couple of ways once robots become more advanced and can take over more manufacturing jobs. The most likely one; the air pops out of the manufacturing balloon for good, and the up and coming countries collapse as their source of cheap labor is no longer a competitive advantage and production is moved back to the west.

The transition to the knowledge economy should have started a long time ago, with the boomers being the last manufacturing generation, and Gen X being the first knowledge economy generation. Unfortunately, this requires fundamental changes in our governments, our economy and our school systems. The school system is designed to create great manufacturing workers, and is built around the needs of someone running a factory. The government is built on the back of "brick and mortar" and manufacturing and the economy is largely built around geographic requirements.

Where a company used to have huge amounts of capital sunk into their physical locations and equipment, now moving your business can be as easy as copying data from one warehouse to another. In some cases, its a matter of putting some data on a flash-drive and getting on a plane. Where industries changed over decades, and products hit the down cycle after 50 years, we are now seeing software companies going from nothing, to billions to nothing in 2 – 3 years in some cases. This speed with which innovation and creative destruction happens has increased massively, while most of our governments are still acting as if this is 1960.

Conclusions/summary

What has happened is an increase in instability. When most production and consumption was local, then local factors largely influenced people lives in a controlled manner. There were external factors such as plagues, or wars, but many small towns around Europe didn't experience much change during the second world war, life went on as it always had.

Where companies spent decades building their brick and mortar models, going from local, to regional to national and finally international, then planned strategy made a lot of sense. So did heavy investments in

efficiency and scale economies.

If we go back 15 years, there were no smart phones, laptops were expensive and fairly rare. Very few people had broadband and were using dial up and ISDN lines to connect to the internet. There was no facebook, no twitter, no wordpress, Apple was suffering from a long-term decline, Samsung was virtually unheard of, and google were the guys powering Yahoo.

Change simply happens faster, and gets more press, this is why you see a growth in “*change management consulting*“, or “*How to become a flexible organization*“. This in and of itself creates the “innovation wars” where “big leaps” become more and more rare, due to the need for “incremental innovation” to stay relevant for the next quarterly presentation. The trouble is though, that change makes it very hard to make big, long-term investments due to the uncertainty you have to deal with.

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