

Simon Johnson: One Page Summary

15.223, class #3: Liberal Market Economies: The United States

Porter's diamond provides an easy way to think about the entire system of elements involved in determining what a country will produce – and which sectors or specific activities will be “competitive”. In this context, “competitive” means that one or more firms has a sustainable advantage relative to firms in other countries, i.e., the country “wins” in international competition, most obviously through exporting.

This helps us understand the pattern of trade and how this may change over time. It also gives us a concrete way to think about what helps or hinders specific firm strategies – for example, demanding local consumers can become a source of competitive advantage (e.g., British tea).

The more lasting determinants of competitive advantage are those that cannot be easily copied elsewhere. “Factor conditions” may have some historical basis – like very strong universities with particular specialties – that are hard for others to emulate (e.g., IITs in India, aerospace in Brazil). Related and supporting industries can be critical in many parts of manufacturing, e.g., autos (e.g., just-in-time production in Japan), but also in software (think about Silicon Valley).

The extent of domestic rivalry always matters, with the interesting irony being that the development of a successful export industry may be more likely when there is intense local competition between several strong players (e.g., Korean chaebol).

Porter also encourages us to think about how scarcity can become an advantage, e.g., lacking domestic energy supplies can encourage energy efficiency (or France's nuclear power). Also if a country has one compelling natural asset – like Singapore's port – what is the best way to build dynamic firms around that?

Porter pushes us to think about trade more broadly than just in terms of real wages – competing just on having the lowest price is often not sustainable. New competition is always developing.

Be careful with Porter's framework, however, because it does not necessarily tell you, (a) where productivity is high, (b) where productivity will grow fast, or (c) what will be the real exchange rate (the latter was what we called competitiveness in 15.015 during H1). One way to think about these issues is to think forward 10-15 years and ask: If we have this competitive advantage and it persists, what will happen to productivity levels?

We can also augment Porter's framework with additional considerations. One element often stressed by other analysts is politics, including the various kinds of relationships between government and business.

In many countries, government tries to help at least part of the business sector – for example with various kinds of advantages. But that also slants the playing field against other firms and, particularly, against potential new entrants. Protecting incumbents is not necessarily the best way to promote productivity growth (e.g., when protected behind tariff barriers or quotas, established firms tend not to be dynamic).

If human capital is such a critical determinant of output per worker, as well as national competitive advantage, why can't we just invest more in education for all Americans?

Would “lifetime employment” help the US today? Why not?

How does Porter's diamond help us think about potential economic growth in Africa?

US Financial Sector

The US financial sector is an interesting case – and one that also has broader implications for both the domestic economy and the way the world works.

At least traditionally, the US government has been relatively “hands-off”. In theory, it sets rules and enforces laws, allowing the market place to take care of the rest. In practice, politicians have close connections with business, through political contributions and other mechanisms. At the end of the 19th century, the US Senate was known as “The Millionaire’s Club.” The libertarian ideal may be attractive but it is hard to achieve in practice – the development of western parts of the US was very much a government strategy (and source of revenue), and railroads in particular relied on government decisions over land use.

With the rise of “trust busting” at the start of the 20th century, the government took a more intrusive but somewhat selective role in determining when markets did not have enough competition. The role of the federal government expanded from the 1930s and, particularly, after World War II – but most of this was (a) military related, and (b) transfers through social insurance programs (including healthcare in the 1960s).

The financial sector was quite fragmented for a long time, but a process of consolidation gathered pace from the 1980s. In part the motivation was creating a sector that could compete with large non-US banks, e.g., from Japan and Europe (and now China).

Porter’s concern, expressed in the early 1990s, was that the system of incentives around traded US firms was too short-term oriented. He is surely right to emphasize the importance of investor preferences – including the way investment managers are compensated.

Porter may have overstated the attractions of “long-term” finance oriented systems. The financial sector advantages of, for example, Germany and Japan look less compelling now than they did 20 years ago. However, within those specific production systems, the domestic financial arrangements make sense to powerful participants and continue to persist.

Emerging economies have struggled with both “arms-length” and “relationship-based” financial systems. Best practice today is to prevent banks from being too close to their borrowers – and definitely to limit the extent of “self-dealing”. But this is hard, particularly when there is a great deal of regulatory capture.

The greatest instance of regulatory capture on record may be that of the US financial sector which, over the past 30 years, convinced policymakers that firms could manage macro-sized risks without jeopardizing the real economy. Executives are often paid based on their return-on-equity, unadjusted for risk.

If a firm is seen by insiders and by credit markets as “too big to fail”, there is a strong incentive to borrow heavily relative to shareholder equity – high leverage means high returns on equity when things go well. Of course, when things go badly, there is a problem – but if there is an implicit government guarantee of some kind, it is largely someone else’s problem.

Porter is exactly right that changing one part of an integrated structure, like the US financial system, is hard. Mostly the problems are about the political power of rich incumbents; they can lobby and buy a great deal of favor – from politicians, regulators, intellectuals. Other parts of the private sector are unfortunately reluctant to stand up to the big banks.

Is this a doom loop or the road to fiscal ruin?

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