Dynamic Economies

by Craig D. Hafer, President

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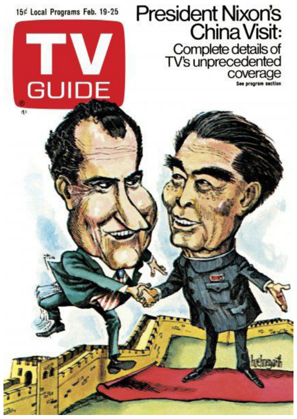
With the world's eyes glued on the Russian invasion of Ukraine, few journalists noted the irony that February 21 - 28, 2022 marked the 50th anniversary of President Richard Nixon's historic trip to the People's Republic of China. Nixon's eight-day visit set the stage for the thawing of the Cold War. The success of his trip to China enabled Nixon to travel to the Soviet Union three months later, for a landmark agreement between the two nations to limit their nuclear arsenals with the signing of the first Strategic Arms Limitation Treaty (SALT). It also marked the beginning of globalization as a tool to improve international relations, where trade agreements would bring China's economic interests closer to the West and raise it from an isolated, third-world country to the second most powerful nation in the world. No one knew it at the time, but China's trajectory would be inversely related to that of the former Soviet Union. In hindsight, the 1970's was an inflection point, catalyzed by technological innovations which would cause economic and political changes that few could have foreseen at the time.



The February 19, 1972 issue of *TV Guide* promoting President Nixon's visit to China. At the time, *TV Guide* was one of the most popular American magazines. In 2008, the company was sold for $1, as the Internet and cable TV had caused weekly circulation to plummet, "creatively destroying" one of the most prized publications of the 20th century.

The idea that innovation is the critical dimension to economic change was theorized by Joseph Schumpeter. In 1942, Schumpeter coined the term "creative destruction" to describe the way in which entrepreneurial innovations lead to the collapse of older, established companies and economic systems. In *Capitalism, Socialism and Democracy,* Schumpeter wrote that economies are dynamic systems that are always evolving. This can create problems for policy makers, as decisions made today can greatly affect what happens later.

Born in 1883, the same year as John Maynard Keynes (one of the greatest liberal economists of the 20th century), Schumpeter was a fierce opponent of Keynesian economic theory. While Keynes advocated for government intervention (such as favorable tax treatment, incentives, etc.) as a catalyst for economic growth, Schumpeter believed that for economic development to occur there must be some disruption, which is often caused by entrepreneurs.

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In a capitalist economy, the changes caused by technological innovations are taken for granted and often celebrated as "progress." It is also accepted that this creative transformation has a destructive side, as it makes earlier products and services (and the workers who provided them) obsolete. Today's consumers have little reason to have a landline phone or camera, when their iPhone can serve as both.

However, in a totalitarian Communist regime such as Russia, creative destruction is sometimes viewed as a threat to the state's central planning, where the government controls economic production, making political power and economic interests one and the same.

For over 100 years, the United States exported more than it imported; however, in 1972, the U.S. economy began to change as imports exceeded exports for the first time, creating a trade deficit. With advances in technology, companies were no longer constrained by their geographic location, and were able to shift their manufacturing to nations that offered cost savings.

By 2006, the U.S. trade deficit rose to $770 billion, or 5.6% of the GDP, before declining to $491 billion in 2013, or 2.9% of the GDP. While the U.S. trade deficit has risen in dollars to $611 billion, it remains at 2.9% of GDP.

As the U.S. shifted to being a net importer, many of the top companies on the Fortune 500 list changed. When Nixon visited China in 1972, the largest company in America (and the world) was General Motors, which stood atop the Fortune 500 above such names as IBM, U.S. Steel and Goodyear Tire. By 2021, Walmart was the top name on the list, followed by Amazon and Apple, with General Motors falling to the 22nd spot. It is of little surprise that 70-80% of Walmart's merchandise is supplied from China, and that Apple relies on China for close to 40% of its parts and many of its products are assembled in China.

Schumpeter's concept that entrepreneurs would cause old companies to perish is generally accepted economic theory. This idea raises an important question at the macro level: if old companies can perish, what about old economies? How is China's rise to the top of the economic order while Russia declined any different from how Microsoft (a company that did not exist in 1972) grew to be larger than IBM?

It is well documented that China viewed international trade as a means to geopolitical power. While Russia invaded Afghanistan in 1979 and attempted to occupy the nation for a decade, China built cities and export hubs to turn their own nation into an export juggernaut. China's rise to becoming the second most powerful country in the world was not the result of invading foreign nations, but through invading foreign markets. In the 1980's, Apple computers were manufactured in Fremont, California. Today, when one orders an Apple computer, it is not uncommon for it to be built in China, then shipped for next-day delivery. Technology disrupted the marketplace and made it less profitable to manufacture computers in the U.S.

Technological change has also altered warfare. Historians credit the use of the long rifle by the Continental Army for their military success over the British, who used the less accurate musket. Much like the American Revolution, when Russia invaded Ukraine, many anticipated it would be a lopsided affair, as evidenced by the quick sell-off in stocks. However, advancements in technology "creatively destroyed" the assumption that the military strength of Russia could easily overwhelm a smaller nation like Ukraine into submission, especially if the smaller nation used modern technology to implement guerilla warfare. When Russia sent a 40-mile column of vehicles, Ukrainians brought them to a halt—not with soldiers, but with a drone brigade.

For investors, understanding that technological growth is the main driver of economic growth in the long run is imperative. Not only do new technologies improve upon existing ideas, they create new opportunities and markets. In the stock market, innovation determines the winners and losers over the long run, which Schumpeter called "creative destruction." Collectively, these technological advancements can cause significant economic change. It is a historical pattern that investors should recognize: technology brings innovation to the market, which causes economic change that can lead to conflict between the winners and losers.

It is the ability of capitalist nations to evolve through creative destruction that has helped the stock market to grow. When Nixon visited China in 1972, the S&P 500 closed at 105.29 on February 22nd. Fifty years later, the index closed at 4,304.76, for a total increase of 3,988%. As the U.S. economy experienced almost every possible scenario, from high inflation to record unemployment, companies adapted and some thrived as they creatively found new ways to react to the changing environment. The oil crisis of 1973 sparked investment into renewable energies that are transforming today's economy, including the arrival of electric cars. Today's rising oil prices may hasten the shift to electric vehicles.

Without question, creative destruction is a dual-edged sword. For example, electric cars, while reducing greenhouse gases, will make those who perform oil changes obsolete. The economic changes that create new wealth can also cause upheaval and sadly, conflict, as the old guard forcefully tries to hold on to power. Schumpeter called it creative destruction, and for 50 years it has transformed not only the stock market, but the world we live in.