TIEMANN
INVESTMENT ADVISORS, LLC

February 22, 2017

The New Industrial Policy

DR. JONATHAN TIEMANN

> *A country that has no mines of its own, must undoubtedly draw its gold and silver from foreign countries, in the same manner as one that has no vineyards of its own must draw its wines. It does not seem necessary, however, that the attention of government should be more turned towards the one than towards the other object. … We trust, with perfect security, that the freedom of trade, without any attention of government, will always supply us with the wine which we have occasion for; and we may trust, with equal security, that it will always supply us with all the gold and silver which we can afford to purchase or to employ, either in circulating our commodities or in other uses.*
>
> — Adam Smith, ***Wealth of Nations*** (1776), Book IV, Chapter I

"Government shouldn't be choosing winners and losers"

When President Obama authorized Federal financial assistance for the US automotive industry as they recovered from the ravages of the financial crisis, numerous conservative commentators lamented that the President was picking winners and losers, when (they argued) a sound economic policy would have allowed the automakers to restructure, and shrink, through bankruptcy.

Those critics presented themselves as principled free-market purists. They argued that if the market decreed that the US auto industry should shed capital, capacity, and jobs, then the only economically and morally sound policy would be to allow that to happen. Investors skilled in the dark arts of bankruptcy litigation might profit, but they would also be serving the broader interest in the same way scavengers clean up the natural environment. Other investors might lose money, and workers would have to find other jobs, but their short-term pain would be part of the necessary and salutary process of economic renewal. The best way to assure that renewal would be for government to stand aside.

Our new President has demonstrated a willingness — an eagerness, really — to meddle directly in the business affairs of a range of US industries, and to single out individual companies for special attention. Some of the same conservative voices that criticized President Obama have objected to this new trend, and for many of the same reasons. Their consistency speaks to their sincerity. The fact is, though, that the US Government has had some kind of intentional industrial policy since Alexander Hamilton presented Congress his ***Report on Manufactures*** in December 1791.[1] We are simply seeing a dramatic shift in both the style and the substance of the national industrial policy.

With the new Administration in office just a month, we can't know fully the shape its industrial policy will take, but we have seen some hints. The new policy seems haphazard, but its general themes seem to include fostering the fossil fuel industries, restricting imports and immigration, and encouraging the repatriation of manufacturing activity that US firms currently conduct outside our borders. Most observers also expect a relaxation of regulations concerning everything from automobile gas mileage to the sale of financial products, along with a set of tax cuts on corporations and high earners. Other, earlier policy proposals include a significant infrastructure spending program.

If these policies come to fruition, who might benefit, and who might lose? In my view, the most likely beneficiaries will be incumbent American firms in established industries, and those that provide capital to them. The policies would generally privilege capital over labor, and could well lead to a reduction in capacity and price increases in some industries. The Administration's policies are not likely to reduce income inequality, or usher in a new golden age of manufacturing employment. The end result could be a further erosion of middle-class standards of living. A robust infrastructure program could offset this to some extent, but if it significantly increases the fiscal deficit, genuine inflation could result. Whether the benefits to business persist beyond an initial bump depends on whether or not this erosion in middle-class purchasing power is severe enough to cause an economic downturn.

1. Alexander Hamilton, *Report on Manufactures*, Communicated to the House of Representatives December 5, 1791.

750 Menlo Avenue
Suite 300 | Third Floor
Menlo Park, CA 94025
(650) 566-0200
www.tiemann.net

How will the new industrial policy play out? Let's look at three specific examples of the President's stances toward particular business situations to see whether we can find clues. We'll look at the news regarding a Carrier air conditioner factory in Indiana, which emerged shortly after the election, the President's meeting a few days after the inauguration with executives from American automakers, and the revival, through executive order, of the discussion surrounding the building of a wall on our southern border.

Carrier Pigeons

Shortly after the election, the then President-elect spent much of one day crowing about a deal he struck to keep a Carrier heating and air conditioning plant open in Indiana, saving about 750 jobs. Carrier had previously announced plans to close two Indiana plants to relocate this production to Mexico. While it appears that Carrier will go through with its plans to close the second plant, which employs a similar number of workers, the deal to save one plant is undoubtedly good news for those Carrier workers that will be retaining their jobs.

The reactions to the Carrier deal were more interesting than the deal itself. Carrier's parent company, United Technologies (NYSE: UTX) is a major defense contractor. In an interview with CNBC's Jim Cramer, UTX CEO Greg Hayes stated that the President-elect had not brought up UTX's defense business when they talked, but Mr. Hayes nevertheless seemed to confirm that the idea that cooperation would be good for his defense business at least crossed his mind. More interestingly, he said that Carrier planned to invest in automation to offset some of the labor cost disadvantage they would incur by keeping the Indiana plant open. In other words, Mr. Hayes allowed that keeping that Carrier plant in Indiana did not mean permanently keeping all the manufacturing jobs currently there.

The Carrier deal attracted critics from the right. James Pethokoukis, an economist with the American Enterprise Institute, a conservative, pro-business, Washington-based think tank, argues that the intervention in Carrier's decision-making has sent a "troubling, even chilling" message to American business leaders. Fears of Presidential meddling, Mr. Pethokoukis argues, could impose on business the nearly impossible juggling act of having to please the market while avoiding annoying the White House. The ***Wall Street Journal*** editorial board argued that the deal sacrifices free-market principles, and even Sarah Palin complained that such an arbitrary governmental intervention in the affairs of a particular private company is redolent of "special interest crony capitalism."

In the Carrier intervention, an unknown mixture of carrots and sticks resulted in the temporary saving of some unknown number of jobs. The deal produced a favorable headline, but it also raised many more questions than it resolved. For investors, the most important reaction was Mr. Hayes's admission that Carrier would seek to increase the automation of the plant to offset the higher wages Carrier pays in the United States. That suggests that however the Administration chooses to intervene in the business decisions of American companies, it will do nothing to interrupt the ongoing shift of economic power and returns from labor to capital. If you're looking for an investment thesis, firms that provide the means for manufacturers to automate (robotics, for example) could do very well. As for the blue-collar labor force, perhaps what public policy should really do for them is provide technical education, particularly in high schools and community colleges. That would maximize both their own economic opportunity and their contribution to the output of the productive economy.

Optimism in Detroit

A second indication of the Administration's industrial policy came from the President's meeting with executives from the major US automakers on Tuesday, January 24. The President summoned them to the White House, presumably to urge, or perhaps cajole, them to repatriate much of the production they are currently running outside the US, especially in Mexico. On the White House driveway after the meeting, CEOs Mary Barra of GM and Mark Fields of Ford both described the session as encouraging.

The Administration's ostensible goal is to encourage the automakers to invest billions to re-establish manufacturing capacity and jobs in the US. The upbeat reaction from Ms. Barra and Mr. Fields might seem to reinforce that impression. But on CNBC after the meeting, Ed Conard, former managing partner of Bain Capital, had a different view of why Ford's and GM's executives and investors might have liked the meeting:

> I think they think they're going to be able to raise prices on cars, 'cause they're not going to add a lot of capacity, so the more we restrict imports, we bump up against capacity in the US and the better off they're going to be, so I'm not surprised that their stocks are rallying in the face of that.[2]

Restricting imports means less total production, which means higher prices because producers can sell everything they make to those consumers willing to pay the most. What restricting imports will not do, Mr. Conard argues, is promote investment and employment. Of course, Mr. Conard might be wrong. He does have a particular point of view — reducing capacity and raising prices have been central pillars of Bain Capital's *modus operandi* since the days when a young, energetic Mitt Romney ran the firm. In any case, what we aren't seeing at work is the traditional Republican orthodoxy of free-market capitalism.

If the President successfully enacts severe import restrictions or taxes, we are likely to see a reduction in auto production, leading to higher prices for consumers, and likely to higher profitability for automakers, at least initially. Parts makers may experience the same benefits, but long-haul shippers, who currently link the various segments of existing international production process chains, may have a rougher time. To the extent that automakers do repatriate production, we can expect a strategy similar to the one Mr. Hayes suggested in the Carrier case — the fitting out of highly automated production facilities.

2. Transcribed from CNBC's "Squawk Alley" program on January 24, 2017. Mr. Conard was responding to a question from reporter Carl Quintanilla. As often happens, the quote reads oddly as text but sounded natural as speech.

Another Brick in the Wall

In its early days the Administration also announced an executive order pertaining to the building of a wall on our border with Mexico, one of the President's campaign motifs. In announcing the order, he repeated his frequent assertion that "Mexico is going to pay for the wall." Mexican President Enrique Peña Nieto responded, in part, by declaring, "Mexico will not pay for any wall," and canceling a planned visit to Washington. The President also suggested that he could compel Mexico to pay by instituting a 20% border tax on goods imported from Mexico. The same executive order also expanded the pool of undocumented immigrants the Government prioritizes for deportation. The Obama Administration had concentrated its efforts on recent arrivals and on those convicted of serious crimes, or regarded as national security threats. The ***New York Times*** reports that in contrast, the new order[3]

> allows the targeting of anyone who "in the judgment of an immigration officer" poses a risk to either public safety or national security. That gives immigration officers the broad authority they have been pressing for, and no longer requires them to receive a review from a supervisor before targeting individuals.

Travel restrictions under a second executive action affecting seven majority-Muslim countries have been lifted pursuant to a restraining order. The first action, however, does appear to have increased the aggressiveness with which Immigration and Customs Enforcement have sought to deport foreign nationals — including, according to anecdotal reports, long-time residents with US-born children — living in the US without legal immigration status.

The ideas of the border wall, stiff immigration enforcement, and the border tax seem superficially beneficial to American workers. After all, the wall, the immigration restrictions, and more deportations of undocumented immigrants would seem to reduce the number of immigrant workers competing with Americans for jobs. The border adjustment tax would operate much like a tariff, raising the prices of goods imported from outside the US, making foreign-produced goods less competitive and possibly inducing some American firms to repatriate production. While the initial effects of these policies might well work in that direction, the longer-term effects could be more problematic.

The potential problem is twofold. First, the immigration-related measures could create labor shortages in an economy where the labor market is already tightening. Second, import restrictions, including the border adjustment tax, could also decrease competition. This increase in those industries' effective concentration could allow US producers to restrict capacity and raise prices. This is the effect that Ed Conard described in his comment on the automobile executives' meeting. While reduced competition might stimulate new entrants into some industries, incumbents would have an overwhelming advantage in any industry where production exhibits economies of scale. Even in industries more readily open to competition, any new entrant would be less cost-competitive than the foreign producers the new policies would affect; otherwise they would already have entered those industries.

A President for Business, not Workers

While the new Administration's economic policies seem superficially favorable to American workers, they are likely to be more favorable to American businesses and providers of capital. As I have argued, manufacturing industries will likely constrain capacity, raise prices, and automate production. Attractive returns to capital, but not attractive gains for workers, could be the results. American business could eventually suffer if the result were a drop in aggregate demand, leading to an economic downturn. They could also suffer in a broader sense if a general enough restriction on immigration were to discourage elite talents from around the world from settling and working in the United States. And over time, severe import restrictions also create the risk of a ruinous trade war.

Some analysts mistakenly assert that if, for example, the auto industry were able to raise prices, the effect would be inflationary. But inflation is an increase in the general level of prices, including wages. Instead, if industries can raise prices because of reduced competition, that would allow them to extract a form of monopoly rent. Workers would find their standard of living lowered, as consumer prices increased without a corresponding increase in wages. In brief, capital seems likely to profit at the expense of labor.

The new Administration's industrial policy seems likely to favor incumbent American producers in established industries. Tax, immigration, and trade policies seem likely to drive concentration and automation in manufacturing industries. All those policies are also likely to drive increased prices for consumer goods, and a lowering of living standards for American workers — Mexico will not be paying for the President's border wall through an import tax; the Wal-Mart shopper will, through higher prices. Businesses and the stock market could do well, unless consumer demand slips enough to cause a recession. It's possible that a large infrastructure plan could forestall that outcome, but it could also increase the deficit — especially if Congress also passes a significant tax cut — by enough to ignite genuine inflation. In all, the President's policies take a simplistic approach to addressing the decades-long decline in manufacturing employment in the US. The policies seem unlikely to succeed in restoring large numbers of manufacturing jobs, but they may nevertheless benefit one of the President's key constituencies, the industrialists and financiers, by giving them increased opportunities for monopoly profits.

Jonathan Tiemann, *President*
Tiemann Investment Advisors
February 22, 2017

3. Jennifer Medina, "Trump's Immigration Order Expands the Definition of 'Criminal,'" New York Times, January 26, 2017