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SCHOOL OF BUSINESS  
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**New Wine in Old Bottles**

**by**

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Fashions come and go in almost all aspects of our society, from the length of women's skirts to economic theories. It was not so long ago that the dreary doctrine of the Club of Rome was telling us that small is beautiful and that the world would run out of resources in some measurable time in the future. After the publication of the Club's initial book, many clones followed; one of my favorite titles was The Failure of Success. The writings of these authors attracted a lot of media attention at the time, but have now faded into well-deserved obscurity.

From time to time over the years, new people step forward and create some media furor with fresh projections that prove to their satisfaction that the end of the world as we have known it is fast approaching. Statistical projections are wonderful things and can be made to "prove" almost anything.

One of my favorites goes like this: if George Steinbrenner continues to behave as he has in the past, some 70% of the male population of New York City will have managed the Yankees by the year 2004.

The key words in all of these projections are "if things continue as they have in the past." What seem like immutable prevailing trends usually do not continue for long because neither human beings, nor the technology they use, continue without change.

Indeed, change is the only constant in the history of man. We don't have to go very far back in history to illustrate the point. Everyone here remembers the great oil crisis. We were told the lights were going out all over the world, and the economies of the industrial world would be brought to their knees. It was only a matter of time, we were assured, before

the Arabs would own America. Those of us who suggested that the market would work--that is higher prices would produce new conservation measures and technology would produce enormous new savings--were laughed out of the room as being unrealistic. Today there is a glut of oil and some now bemoan the fact that the price has fallen so far that we in America have the lowest rig count in years. This situation also will not last, although there now appears to be no end in sight.

If change is the only constant in our lives, perhaps Arthur Clarke said it best when he opined that "The future is a foreign country: they do things differently there." Right now a very good case can be made that we are moving rapidly toward a future where they do things differently and we are already late in recognizing some problems. The old industrial

age that we have known is slowly fading and blending into a new information society. The advent of the information age does not mean that manufacturing does not matter any more than the arrival of the industrial age meant that agriculture disappeared. What it does mean is that we will produce more and better goods with less labor, just as we now do on our farms.

The transition from one era of economic development to another has always created trouble for those who found it hard to believe that the world had changed, and thus failed to adapt to new circumstances.

Those of you who follow the economic forecasts dispensed by various services, government agencies and economists at large, may have discerned a certain sameness about their prognostications for the

last five years. The standard forecast has run about as follows: "We were somewhat surprised by the strength of the last quarter, but anticipate that the next quarter will be weaker and that the recession will occur in the 4th or 5th quarter out." This forecast has become so standard that you might as well put it on tape and play it back each quarter. The problem with the forecast has been that it was wrong. It may well be, that like the stopped clock which is right twice a day, this forecast may eventually be right, but it has not been a very reliable guide for policy decisions. It is hard to find a period in history where so many forecasters have been so wrong for so long. Since the skill of the economists putting together these numbers is very high, the question then arises as to why they have been so far off for so long.

The first step in solving any problem is to try to get the facts. This is not always as easy as it sounds. And it is particularly hard now that we are living in the morning of a new age. Each time the economic tectonic plates shift as one age fades into the next, confusion abounds, since new words must be invented to describe new happenings, and measurement systems that were once adequate may no longer reflect the new reality. Reform is delayed because old power structures get very nervous and wonder if their control will survive the demise of their familiar world. Their concerns are well founded. Some fifty years ago, roughly 33% of us lived and worked on a farm, while today less than 3% of Americans farm. Yet our agricultural output is one of the wonders of the world. We have stood Malthus on his head. The problem is not whether man can grow

enough to feed an expanding world population, but rather how to find the **political will** to distribute the surplus. / At the time of the transition from an agrarian to an industrial society, not everyone saw it as an opportunity. / Indeed, President Franklin Roosevelt put it this way: / "Our industrial plant is built...Our last frontier has long since been reached and there is practically no more free land. / More than half of our people do not live on farms...and cannot derive a living by cultivating, their own property." / While this may sound strange in today's context, echoes of this brand of **backward-looking philosophy** are now being heard about the fading of the **industrial society**.

On the business front, companies rise, fall and disappear. / The names of the companies that make the Fortune 500 change dramatically from year to

year. Indeed, only about one third of the companies which made the list 30 years ago are still there. Whole industries have disappeared, and new ones have taken their place. Those businesses which are priced out of the market by more efficient competitors, or whose product is being superseded, often ask for government protection, even though in the end this alone will not save them. This ebb and flow in an economy was labeled "creative destruction" by the great economist, Joseph Schumpeter and it still goes on today.

The transition from the industrial to the information society which is now occurring, not only makes this process more visible but also makes the measurement of how our economy is performing extremely difficult.

It is not too far from the truth to say that the very concept of society's capital base is in the process of changing once again. The vital skills of the hunter, which gave way to those of the farmer and the miner, are now moving toward those who master information. Information is both an item of consumption and a means of production. The shift from an industrial to an information society thus impacts not only the types and quality of jobs, but also the value of raw materials, the importance of geographical locations, and the nature of business and politics. Will a few pounds of common sand in a microchip or fiber optic cable replace tons of copper with a consequent effect on the world-wide mining business? Will the mobility of capital moving across borders with the speed of light impact forever the old concept of national sovereignty? These, and many

more questions crowd in on us if we have the courage to face them. Peter Drucker has written: "The shift to knowledge and education as the passport to good jobs and career opportunities means, above all, a shift from a society in which business was the main avenue of advancement to a society in which business is only one." If the world is changing this dramatically, and it is, how then do we measure what is happening to our economies?

If one reads the history of the Napoleonic Wars, one can learn about the number of men and cannon employed, the number of horses, the number of muskets, and even the quantity of food that had been supplied. What you do not find are references to the number of bomber sorties flown, the power of the thrust of jet engines or the number of fly-by-wire missiles launched. The reason obviously is that none

of these things had been invented, and indeed the vocabulary to describe them had not been formed.

A good case can be made that we are in a similar position today. Many of the old measures of economic problems and progress, success and failure are rapidly losing their usefulness because they were constructed before many modern business and social enterprises were invented. Almost invariably when suggestions are made to change and improve measurement systems, some one will accuse you of cooking the books. Actually, it often turns out that retaining old measurements may distort reality. Examples abound. When Mount Rainier was first measured in 1842, the surveyors of that time underestimated its height by 2000 feet. Recent surveys corrected that huge error, but the latest measurement, made by three dimensional satellite

surveying on the 100th anniversary of Washington's statehood, added more than a foot to what scientists only recently believed was the correct height. In this instance the mountain itself stayed the same, but the measurement system improved. In the economic sphere, just the reverse has occurred. Much of the economic hysteria that seems to have become a constant background to contemporary discussions of government policy or business strategy is traceable to the increasing inaccuracy or irrelevance of our standards of economic measurement. The declining accuracy of these standards in measuring today's world seems to be one reason so many very good economists lately have been so wrong about the direction of the economy. Even very good people using bad information will make bad calls.

Over the centuries there have been many efforts to measure economic events and to encapsulate economic truth. One of the early attempts to find some answers was made by the consulting physician to Louis XV, Francois Quesnay, who tried to design a universal law which would do for economics what Newton had done for physics. He argued that the source of all wealth was land and that agricultural products, produced in abundance and sold at high prices, produced wealth. His disciples, who eventually became known as Physiocrats, had a profound influence on many important thinkers, including Benjamin Franklin, who wrote: "Agriculture is truly productive of new wealth; manufacturers only change forms, and, whatever value they give to the materials they work upon, they in the meantime consume an equal value in provisions." This view

that manufacturing **does not create value** would no doubt surprise and be rejected by the modern industrialist appearing on "Meet the Press." Their view is that **only manufacturing creates value** and they dismiss the service business as hamburger flippers and car washers in much the same manner that the Physiocrats dismissed manufacturing years ago. / Aside from the emotional capital people have invested in one point of view or another, we often lack the measuring sticks to lay against a new situation.

The old measures may convince us we have **failed** when we are succeeding and persuade us to turn about in vain pursuit of our past rather than successfully navigating the future. / This may account for the inability to predict our successes and failures

If we have been trying to promote economic growth with low inflation, we have succeeded. If we have been trying to create more new jobs than any other industrialized country in the world, we succeeded. By contrast, in the countries that comprise the Common Market, almost no new jobs were created in the last few years, while more than 17 million new jobs helped fuel the American economy. Dispute exists about the nature of some jobs created and, indeed, whether these jobs produce wealth. Presumably, however, everyone can agree that from a national viewpoint a growing American economy is desirable. How then do we keep it healthy? What is it we must do?

Paul Strassmann put it starkly: "We lack indicators", he said, "that would more reliably illuminate the two key economic issues for the 1990s:

how to improve international competitiveness and how to promote the economic growth of a society in which two-thirds of the value of labor is devoted to communication." If we are to cope successfully with the information economy we may have to develop new standards to measure economic success and failure.

Many of the accounting concepts and rules which have been developed over time are designed to reflect businesses operating in the industrial age. Against this background it is understandable that assets recorded on balance sheets tend to be something that you and I can feel and touch, like a building or a machine tool. Intellectual capital tends to be expensed, since it is not regarded as a "real" asset, while physical capital tends to be capitalized. The magnitude of the distortion produced by these

accounting systems can be suggested by the fact that in a recent five-year period IBM alone had revenues from selling software totaling almost \$17 billion, and this number does not include any development expenses. This \$17 billion, along with billions more produced by other vendors, has almost disappeared completely into thin air. It appears on nobody's balance sheet. Certainly it is prudent to question whether or not this accounting treatment truly reflects the strength of American business. It is almost beyond argument that many businesses would collapse if the software were not present to keep their systems running. On the other hand, the last few years have demonstrated that a great many corporations can get along very nicely without some of their "real" balance sheet assets. If today's installed software suddenly disappeared, factories

would stop running, accounting activities would all but cease, trains, trucks, buses and airlines would come to a halt.

Surely if capital is something that produces a flow of income, much of the world's software fits that description and deserves better accounting treatment than it now receives. On the government side our statistics about information, or knowledge workers, is totally inadequate to the task of supplying useful data to policy makers. The SIC-based government statistics are still largely based on physical output even though information is becoming the dominant determinant.

We don't do much better on a macro basis. All estimates, from whatever source, of what our Federal deficit is going to be in the future are by necessity based on someone's idea of the future growth of our

G.N.P. The rosy scenario clashes with gloom and doom. The facts are that no one knows just how the economy will behave in the future, and the Government is incapable even of telling us what the last quarter's G.N.P. growth was with any precision. Final figures are not issued until three years after the close of a quarter. The difference between the Commerce Department's first reports on the G.N.P. for a quarter and the ~~financial~~ figures show huge variations. If, for example, the initial report indicated a G.N.P. growth of three percent, half of the time the final figure would show a growth of less than 1.5 percent or more than 4.5 percent. One time in ten the adjusted final figure would show less than one half percent or more than 5.5 percent. Figures that move about that much rarely furnish a firm foundation for policy decisions.

In addition to the problem with the numbers themselves, most economic theories are based on the concept of more or less independent national economies.

While this view once had some validity and, indeed, is the framework surrounding much economic theory from Adam Smith to modern times, the world can no longer be understood as a collection of national economies managed in isolation from each other. The reality of a global market, tied together with an electronic infrastructure, in which capital flows drive trade, has created a **totally new state of affairs** which we are only just beginning to understand. Borders that were once the cause of wars are now becoming porous. Money moves over, around and through them with the speed of light. The flows of capital are now in the range of 30 to 50

times greater than world trade. The world's capital which moves along this electronic highway, goes where it is wanted and it stays where it is well treated. The truly global market which now exists, creates a totally new situation in the world.

While national economies are still important, they may no longer be determinant. Information about national policies is no longer confined by lines on a map, but moves around the globe with the speed of light to appear on the more than 200 thousand screens in the trading rooms of the world. Traders react instantly to this information and buy or sell a currency, creating a global plebiscite on any government's policies. This state of affairs has created a new standard by which economic policy is judged: The Information Standard. National economic policies are instantly applauded or

condemned and this sentiment is translated into exchange rates. This information is in a sense stateless, like Eurocurrency, and will force governments to change their ways--as President Mitterrand of France learned in 1981 when, after only a few months, he had to abandon socialist policies. The whole world now knows that the socialist model does not work, but they are also are learning that free governments must increasingly work together to harmonize policies. To do this effectively we may need a different vocabulary to describe this new world, and we need new national income accounts, new accounting in business, and trade figures which reflect the horizontal integration of world business. This is a tall order, but most of us now have on our desks more computing power than existed 25 years ago, so it is well within our capacity. The sooner we

**get on with it and can get it done, the more reliable will be the data on which to base policy decisions in the future.**

