Learning to live with the New Economy…The tangible manifestations of the current U.S. economic slump have reinvigorated the Old Economy/New Economy debate. The Old Economy's champions, pointing to stock market woes, consumer sentiment worries, declining manufacturing activity, and corporate layoffs, see familiar patterns at work. New Economy advocates argue that even as the economy endures an adjustment period, it does so in different ways and will emerge in a different place than it used to.

Does this Old Economy/New Economy dichotomy offer us anything useful from which to learn, or is it a distinction without a difference?

First, let's define the Old Economy paradigm. In this world, business cycles are endemic to the economy's operations because it is so hard to coordinate production and sales. Inventory buffers are stockpiled at links in the supply chain between manufacturers and consumers to smooth out normal imbalances between supply and demand, but these same stockpiles can create large disturbances if they swell just before demand shrinks. When that happens, manufacturers are forced to scale back sharply or shut down completely while the stockpiles are worked off, usually at deep price discounts.

The resulting declines in profitability feed back through financial markets, impairing firms' ability to raise funds when they need them most. Labor markets slacken, the unemployment rate rises, and hiring cost pressures ease. Economic activity remains at low ebb until excess inventories are cleared out, marginally profitable operations are sold or improved, and balance sheets are repaired. Hiring and investment spending resume only after firms are forced to expand capacity once again, and when banks are able to finance more projects.

The New Economy, its advocates say, is less fragile. Where the Old Economy was rooted in manufacturing industries constrained by decreasing returns to scale in production, the New Economy is built on information and technology industries that show increasing returns to scale in production and positive externalities. Waves of innovation guarantee that firms can constantly lower their cost structure and promise consumers a continuously improving array of choices. Living standards tangibly rise, as does the quality of life. The dynamism associated with these innovations also ensures new and profitable investment opportunities and a steady supply of rewarding jobs. People accept change because they see it as a bridge to a better future.

The New Economy is also free of the boom-and-bust pattern that plagues the Old Economy. Inventory rebalancing, such a prominent source of transmission in the Old Economy paradigm, is far less important in the New Economy of advanced supply-chain management. New Economy firms directly tie their information systems together, enabling them to continuously match orders to sales.

Moreover, New Economy firms and their investors have long planning horizons. They see the merits of increasing market share, expanding globally, and acquiring smaller competitors. With new technologies to power their businesses and sell to others, the entire New Economy has a solid underpinning that is impervious to cyclical fluctuations. Its financing comes not just from banks, but from global capital markets. While the Old Economy was about job security and Social Security, the New Economy is about creative destruction and the privatization of retirement wealth.

But just how profound is the change? High-tech investment, the lynchpin of our decade-long expansion, has nearly stopped growing, while the NASDAQ's much-vaunted invincibility has crumbled. One Blue Chip firm after another has fallen short of its earnings projections. An old-fashioned inventory correction seems to be under way, with especially severe repercussions echoing through the transportation equipment industry. Lenders are applying tighter credit standards to their customers. Consumer and business sentiment has been poor. Certainly none of these conditions fit with the beguiling portrait that ardent New Economy advocates have been painting. Yet, something does seem different.

Productivity has improved significantly during the past several decades, especially in manufacturing industries. New technologies are surely important, but there are other important factors to consider. Businesses invest in new technologies when they can put them to use profitably. Those circumstances are far more likely to prevail in an environment of low inflation and increasingly open borders—conditions that have prevailed for the last decade. Competition and property rights are just as important to intellectual property as they are to physical assets. The New Economy is new, not only because of its application of new ideas, but because it relies on some sound old ideas as well.