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## listeningin

### Growth: Slow In The Short Run, But...

*Larry Siegel Parses Reasons We're Not Necessarily Stuck With Stagnation*

*Some people are well-read, and then there's Larry Siegel — Laurence B., if formal you must be. If it has to do with economics or investment research — or literature or music or gosh knows — ask Larry and you'll be enlightened — generally in the most-good humored of ways, even though the man always has an impossible number of projects on his plate.*

*Larry may have retired from the No. 2 slot in the Ford Foundation's investment operations a few years back, but he's hasn't slowed down a bit. He now serves as the Gary P. Brinson director of research as the CFA Research Institute, even as he's publishing his own pieces at a pace that would put even an ambitious young tenure-track academic to shame. Lately, not a few of Larry's papers have delved into the question of growth. Are we really stuck in "secular stagnation?" If not, where did growth go, and when is it coming back. Listen in.*

**Growth is the question, Larry, and you've been writing about it quite a bit. Are you still the unabashed optimist who penned "Fewer, Richer, Greener"?**

LAURENCE SIEGEL: In the long term, yes. In the shorter term, the question is for how long this



Larry Siegel

painfully slow growth will persist — and why and what can we do about it? You've caught me in a fairly bad mood — because Great Britain, due to a series of fairly stupid mistakes, is voting today on whether to self-destruct. [The Naes carried the day. Hooray.]

**It would make a fascinating coda to the history of the United Kingdom, if only it were happening in a vacuum.**

But it's not. So it's not fascinating. It's a disgrace. Because of the ruthless efficiency of the parliamentary system, they gave the power to terminate the existence

of their country to 51% of an 8% minority.

**I think our ancestors fought the Civil War essentially to prevent that.**

Yes, we thought the union was a bit more important than the British seem to. Granted, there are people still arguing about whether the Civil War was worth all of the lives it claimed, but it set a precedent for leaving borders alone that has lasted a long time.

**Among other things... Scottish independence would be an economic nightmare. We can only hope cooler heads will prevail.** Basically, people on the margins who have nation-

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alistic or sentimental reasons for wanting independence are being manipulated. The people doing the manipulating simply want more power — more government — and they are in the government.

But you asked about economic growth. There has been a little since the Great Recession ended. It's kept up with population growth and then a little more. But when growth has been as slow as it has been for a long time, people get discouraged. Not only is the half-of-a-percent or one percent per capita growth that we're getting barely perceptible, it doesn't take place evenly: A certain number of people do fairly well and a certain number of people do extremely poorly.

**Plus, those "certain numbers" are anything but equal.**

Yes, the number of people affected adversely is large. The burden is on the young and the unskilled. In the 1970s, the burden was on the rich.

**It was? It sure didn't feel that, way back then.**

When you're young, you feel as though everyone else is rich and you are poor. There's some truth to that, but it's only temporary, even today. In the 1970s, although youth unemployment rose into double digits and stayed there, those people (who included me and probably you) had time to recover and later prosper. But bond holders lost most of their life savings, as did stock holders for a while. Stock investors would have had to hold on through extremely trying times during the bear markets of the '70s in order to make it back in the '80s. In the U.K., capital destruction was worse than in the Great Depression, although in the U.S. it was not as bad.

This time, in contrast, the stock market is up, the bond market is up, the housing market is up. But the labor market is extremely distressing — so people are discouraged. But I want to make several points here.

**Go on —**

David Adler, who's a Bloomberg contributor and

documentary producer and also a grantee of the CFA Institute Research Foundation, where I work as research director, has recently written a book that's going to come out this year on liquidity and financial frictions. In it, he points out that financial crises are different from other crises. This thought is not original to him, but I've been reading his book, so it's been influencing me. Paraphrasing: A financial crisis takes out an important part of society's infrastructure — and leaves it out of operation for an extended period of time. It's as though you closed the roads or the airports or the electrical grid and just left it closed down while somebody worked on it for a few months or a few years.

**"If this mood continues for too long, we destroy some of our power to produce by over-redistributing, over-regulating and over-borrowing and over-taxing."**

And the inability of the financial system to make loans and otherwise function as it's supposed to do — as a piece of social infrastructure — removes a substantial part of GDP. So what could have been produced during that period is gone forever. Even if you later catch up, there's a cost to the delay because some things that need to be

produced need to be produced in current time. If you have to wait, you lose. And, in this instance, it has been six or seven years and we're still waiting.

**But the economy has improved a tiny bit, at long last. And as Mom always said, "There's no use crying over spilled milk."**

Right now, happily, there are signs of an upturn. But to get back to the 1.8% real per capita GDP trend line we'd have to get a string of 4% or 5% — those numbers being real GDP growth rates. We're just nowhere near that. So this is a dangerous time. And I rarely say that. Usually, if things are looking down, I think they're about to turn up. If they're looking up, I think they're about to turn down. There's not much new under the sun.

**Then why are you so uncharacteristically glum now — besides Scotland?**

Because what's happening is that people are losing confidence in their long-term ability to produce.

**So you are worried about the social impact of slow growth on stability and such?**

Yes. People are fearful. People want certainty — or the illusion of certainty — not the freedom to create and innovate, which they have stopped caring about.

**That's a pretty sweeping – and dyspeptic – generalization.**

Hear me out. The illusion of certainty can come from dictatorship, as in Russia, or it can come from a policy of generous handouts and transfers and entitlements, as we see in Europe and America. But if this mood continues for too long, we destroy some of our power to produce by over-redistributing, over-regulating, over-borrowing, and over-taxing.

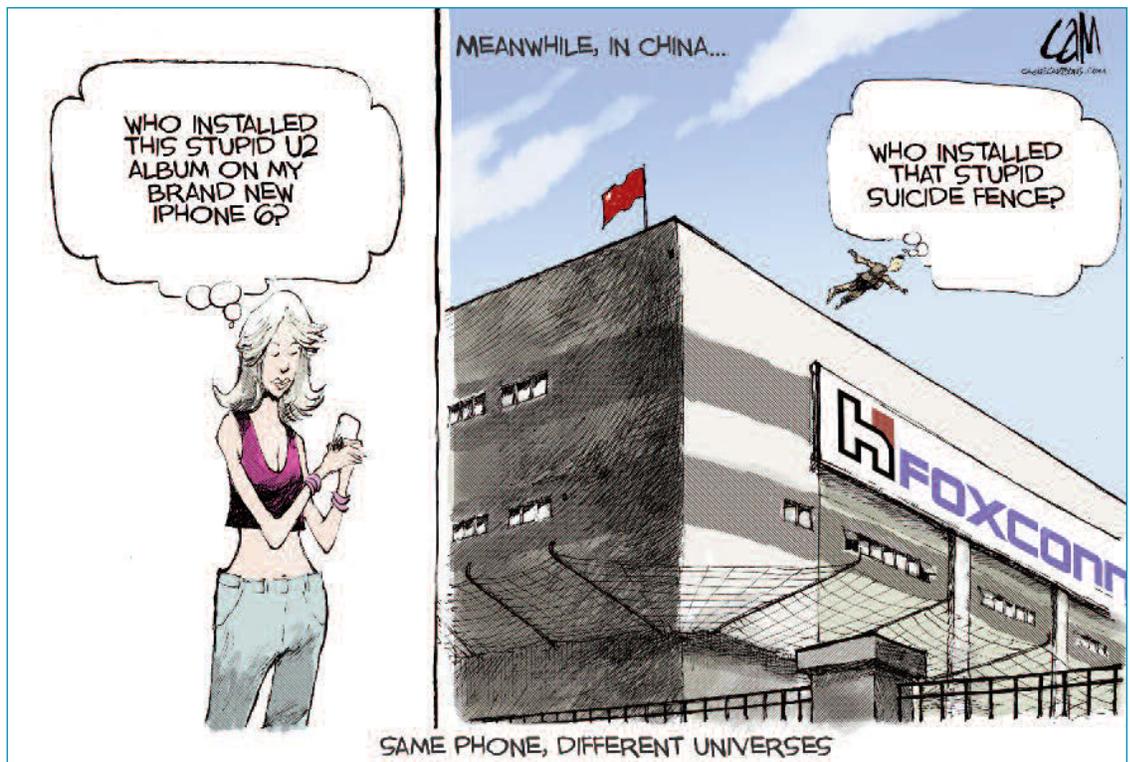
**Aren't you going a little over the top?**

It sounds like over-the-top rhetoric, but it's hard to overstate the extent to which I'm concerned about the sharp turn toward what I call "soft socialism," the socialism of high taxes on work and high government benefits that discourage work. The old socialism was state ownership of the means of production. Today's socialism is an easier sell in that the means of production are owned privately, so you can make a profit. But, as a worker, unless you're a highly-paid professional or manager, you can't make much money, due to layer upon layer of taxes. No wonder people aren't working.

And there is a ratchet effect. Since more government is the answer to every problem, and there are always new problems, the size of government grows and grows. This year or next, the median worker — that is, a worker making the median family income in this country — will face a marginal tax rate, from all taxing authorities combined, of more than 50% for the first time. That's not good.

**What happens if people work less, for whatever reason?**

The incentives to avoid working divert real eco-



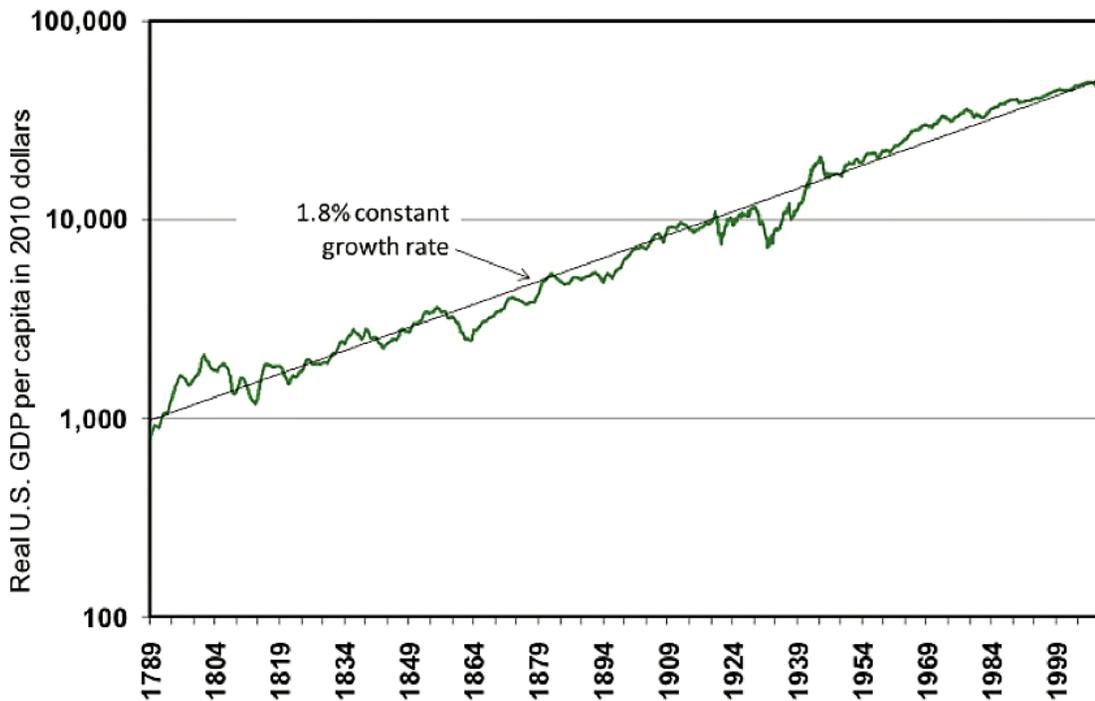
nomical resources from more productive uses to less productive uses. It's not rocket science; we all learned in Econ 102 or 103 that when you tax something, you get less of it. We've already cooked our goose to some extent — though there is still room to reverse it. My concern is that the secular stagnation that we seem to be in may not have any real basis — but we could talk ourselves into it. It becomes a self-fulfilling prophecy if we do that.

There is no fundamental technological reason for this stagnation. Technology is continuing to advance at a historic rate — and if you don't believe it, just read *Scientific American* instead of *The Economist*.

**If you think Larry Summers' secular stagnation is still just in our heads, then you still side with Northwestern Professor Joel Mokyr – and not with his pessimistic Evanston colleague, Professor Robert Gordon, in their friendly debate over whether economic growth is a thing of the past? At least so far –**

That's the key. So far, Mokyr isn't a macroeconomist like Gordon. But he is still an economist — an economic historian — and he's trying to make sense out of what's going on in the technology world. I think he's doing a very good job of it. But he is still a secondary source. He is explaining, as a reporter would, what he is reading in *Scientific American* and *Nature* and the other journals. That's

## U.S. Real GDP Per Capita, 1789-2012



Source: William F. Sharpe, P. Brett Hammond, Martin L. Leibowitz, and Laurence B. Siegel. "The Equity Risk Premium." Presentation at the Q Group, Dana Point, CA, October 16, 2012.

cer cells to commit suicide. These are not a fantasy — they've been developed at Harvard.

Now, there's no denying that growth may slow as Gordon says, especially when measured by GDP — if only because population growth might be slowing. But per capita GDP, not overall GDP, is what counts for measuring the standard of living. And even a slowing in per capita GDP growth wouldn't necessarily mean that the improvement in global standards of living would slow at the same pace. The measures of per capita GDP simply miss

where you find the original research that actually tells us about the scientific discoveries and technology changes that are taking place —

**So Prof. Mokyr is performing a not inconsiderable service. That original material is demanding, to say the least.**

No kidding! I can't read that original research. I just don't have the technical background.

**Most of us don't, by definition.**

But I do know that people who are wiser and better informed than I am in the realm of science say that the pace of technological change is astonishing; that we can't even begin to imagine what changes will take place in our lifetimes.

**Like what? Prof. Gordon's argument is that the really big, life-altering discoveries, from flush toilets to computer, from railroads to jets, have already been made. So future inventions just won't add much by comparison. Implying, of course, that the rapid human development over the 19th and 20th Centuries was a fluke.**

There's movement that's occurring all over the place in every field: biotech, energy, clean tech, metallurgy, agriculture, manufacturing. I just read about anti-cancer nano-robots that reprogram can-

some of ways that advanced technologies make life better.

**Sounds like we need a better way to measure growth.**

Even if we had a perfect one, it's worth pointing out that no growth rate can continue forever.

**Even I took enough math to grasp that.**

Well, Jeremy Grantham of GMO is fond of pointing out that if an ancient Egyptian consumed one cubic yard of physical materials — which seems a reasonable amount by today's standards — per year in 1000 B.C., and if his consumption grew at only 2% a year (roughly the rate of per-capita consumption growth in the developed world in the last 200 years), that a very long-lived Egyptian would be consuming more than the volume of the planet each year by the present time. Such expansion can only continue for a finite amount of time, if consumption of physical materials is what we are talking about.

**Point taken. But maybe the bigger point is that maybe growth isn't slowing as much as it's shifting into areas we're not so good at measuring with GDP?**

It's well known that there are problems in econom-

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ic measurement, and Gordon and Mokyr are involved in that debate. Without saying so, Gordon appears to believe that GDP measures economic activity with enough accuracy that more GDP can be presumed to be better than less.

**That would seem to be the least you could ask of a measurement tool – in any field other than economics!**

But it is not necessarily the case in economics. GDP basically says that a good or service is worth what you paid for it. If you could suddenly accomplish the same thing with a new technology that costs less, that would be an improvement in the quality of life but a decrease in GDP. This sort of substitution happens all the time.

**For example?**

Anesthesia. Joel Mokyr notes that the introduction of anesthesia in the 1840s was one of the greatest improvements in the quality of life in human history. How would you like your leg sawed off with whiskey as the only painkiller? All of a sudden, that was no longer necessary, and modern surgical techniques began to be possible. Yet the contribution of anesthesia to GDP was negligible.

**How does this principle apply to modern life? What innovations are we enjoying that don't add to GDP, or that possibly subtract from it?**

Innovations that are primarily cost-saving cause GDP to decline, even though utility increases. Think ride sharing (Uber and Lyft), residence sharing (Airbnb and VRBO) and free advertising (Craigslist). Services such as those not only reduce costs but also take transactions out of the measured economy. Even if everyone involved in this new “sharing economy” fully reported income and paid taxes on it, the cost saving would mostly accrue to the consumer and not be counted in GDP. The same can be said of improvements in computing, telephony, and fuel-efficient driving.

What this means to me is that GDP does not have to grow as fast as in the past because the pile of stuff we use in our lives is reaching satiation. But progress in the sense of needing to exert less effort to achieve the same utility has no natural limit.

**And isn't one of the big points of the technological optimists, like Mokyr, that economic growth no longer depends on increased consumption of natural resources?**

Yes, Mokyr would say that economic growth means

a reduction in the effort needed to produce a unit of utility, not necessarily an increase in the consumption of physical materials.

**Sounds like good news for Mother Earth. Perhaps we should back up and be specific about what sort of slowing has spawned so much “Chicken Little” debate about growth falling.**

That's why I sent you that chart [above]. It shows that U.S. real per capita GDP (which, however imperfect, is the best available measure of economic productivity) grew at 1.8% a year, on a long-term basis, and that growth has recently slipped below trend.

**As the chart also makes clear, it has done so on any number of occasions since the founding of the Republic. But Larry Summers is suggesting this is no mere cyclical fluctuation. You're not worried?**

Well, Gordon's pessimistic argument can basically be summarized, as you suggested, as the low-hanging fruit has been picked. We won't invent indoor plumbing again. Or cars or rockets. So, he posits, “The rapid progress made over the past 250 years could well turn out to be a unique episode in human history.”

**Or not.**

It's obviously unique in that nothing like it ever happened before, and now that the basic tools of modern life have been invented, we don't have to invent them again. But that is kind of a trivial observation; it says nothing about what comes next. Gordon argues that future improvements will be successively smaller and that fantastic new breakthroughs are unlikely, because of six headwinds to growth that he has written about.

**Remind me, they are – ?**

Demography, educational shortcomings, inequality, globalization, energy and environmental constraints and the overhang of consumer and government debt. Gordon's conclusion is that consumption per capita is likely to grow as slowly as 0.5% per year “for an extended period of decades.”

**You don't entirely discount all of them, from what you were saying earlier.**

Some of Gordon's headwinds are a real concern. The aging of the population will make labor (and tax dollars extracted from it) scarcer. The root causes of aging, however, are longevity and a low birth rate. And those, as I argued in my 2012 essay, “Fewer, Richer, Greener,” are huge positives

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for the economy and environment. [WOWS 1/11/13]

What I am more concerned about is that entitlement spending is crowding out needed infrastructure projects. We need to educate and train low- and middle-skilled workers. But I am more persuaded by Mokyr's argument that headwinds to growth are nothing new — the 20th Century was full of headwinds that threatened not just growth but the survival of the human race — and that it ended up being the most successful century in history, in economic terms.

**I guess Gordon would say that was precisely why the period was exceptional.**

Well, most historians attribute the economy's "growth spurt" (if that is what it has been) to engineering, entrepreneurship and capital accumulation, but Mokyr tends to attribute our success to the ripple effects from basic discoveries in the natural sciences that have been propelled — and continue to be propelled — by a raft of "tailwinds."

**Gee, are we airborne yet? Like what?**

I haven't heard Joel Mokyr enumerate all the tailwinds he sees. But my own list includes:

- Relatively free markets and trade.
- Patent protection, which allows inventors to capture the rewards of innovation.
- Instantaneous and almost-free global communications.
- Cheap, safe air travel enabling innovators to collaborate, socialize, and sell.
- Widespread use of English — our language — as the world's common language.
- Outstanding universities, worldwide, that could create a global education network on the internet.

**You dreamer, you.**

Well, there are headwinds and tailwinds. You asked me to name the tailwinds. Still, most of this stuff has barely begun to be exploited. Hence, the growth potential. Mokyr actually would say that this forward movement is driven not by discoveries in pure science — like the laws of quantum mechanics — but by a complex dance between technology and science that is widely misunderstood. Most people imagine that scientists in white lab coats discover new scientific principles — and then, some day, some how, those new principles are used by engineers to produce new technologies.

But Mokyr would also have the process flow the other way. The economic demand for innovation — the need to do things more efficiently, more cre-

atively and just differently — enables us to discover new scientific principles where we weren't even looking before. So he says human advancement — and economic growth — come from the interplay of two quite separate aspects of technology, the techniques, or recipes, for doing something useful; and knowledge or discoveries of natural laws.

**Then he's suggesting that progress isn't linear; that there are a lot of subtle feedback loops between the pure scientists and technological innovators?**

Yes. To illustrate how this works, Mokyr has reached all the way back to 1600 to find an example simple enough to describe in plain English. Hans Lippershey, an optician, first put two lenses at opposite ends of a tube and found that you could see at a distance, inventing the telescope.

**Okay, so?**

Lippershey wasn't trying to observe the moons of Jupiter or the rings around Saturn: He had no idea they were there. He just wanted to look at ships. But Galileo applied the telescope to something new, pointing it to the sky. And Galileo's discovery of moons in orbit around planets required a new theory, which Newton, later in that century, called gravitation. So a new theory of the universe came directly out of the technological innovation of placing two lenses at opposite ends of a metal tube so you could see ships at a distance more clearly.

Social needs, then, can drive technological needs, which drive abstract scientific knowledge — the flow is not just one way.

**Or at least it wasn't in the 17th Century.**

And it isn't now. Mokyr argues that the same sort of interplay of the practical and the theoretical aspects of technology that made possible the Age of Reason and, eventually, theoretical physics, is going on right now. He persuasively points out that now we can apply a tool never even dreamed of before — high-powered computing — to any kind of research, not just in the natural sciences — and that it's quite quickly become unimaginable to do it any other way. He says electronic computing is the most powerful research tool ever invented. What's more, we've barely just begun to exploit its availability. "Think about the chemistry and the physics and the nanotechnology that these machines will develop and what further instruments. You will see mutually reinforcing processes that will launch us into an orbit that we today cannot imagine." That, Mokyr explains, is why he is an optimist.

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## So you're persuaded?

Yes. Another place where we're seeing that interplay right now is in medicine. People want a cure for cancer. Well, we don't have a cure for cancer but we're learning an awful lot about cellular biology that we wouldn't have learned if there weren't billions or maybe trillions of dollars in potential profits for anyone coming up with partial cures for cancer. The needle is starting to move. All of us, I think, know people who have had cancer and are alive and well. Many of them will live for 20 or 30 more years and have productive lives and some will simply be said to have been cured. This possibility didn't exist 50 years ago.

## Thankfully, it does now. One of my sisters is alive and kicking five-plus years after a stem cell transplant, from another sister, which cured her acute myeloid leukemia.

Stem cell transplants are an innovation I never heard of only 20 years ago, and there's a lot more where that came from. I joke that the internet is a transitional technology — between books, in the past, and piping information straight into my head, in the future. But it might not be a joke.

## Now, there's a question: What will make the web obsolete? Inevitably, something will.

I don't know enough about information technology to answer that, but in the year 3000, our descendants will look back on our current regime of medical treatments as unbelievably barbaric.

## Just look at the unfolding Ebola catastrophe in Africa –

It brings into sharp relief another of the points I have been making. Even if the basic tools of a technological society have been invented, we have another huge task at hand: Using those tools effectively. Technology diffusion is just as critical to progress as invention. Which produces a greater improvement in human life and in global GDP, a consumer in India or Africa buying his first car or an American trading an iPhone 5 for an iPhone 6?

## The new car, clearly.

Right. It produces an improvement in total utility many times larger than the iPhone trade. The quality of life enjoyed by the global middle to upper-middle class is pretty good. If it could be expanded to include almost everyone in the world (pathological cases aside) and if such a way of life could be maintained indefinitely into the future, it would represent a stunning achievement by the human species.

## I'd say.

But such an outcome would not look impressive if measured by developed-country GDP growth rates, because these countries are already most of the way there. Emerging countries, continuing the “great convergence” that has persisted since around 1950, would grow rapidly for a number of decades as they catch up. Then, global growth as measured by GDP could slow to a crawl.

## But only if you assume everyone would be fat and happy and never have another original thought –

Which I rather doubt, in part because of what has been called technological biteback. The technology we need and want creates new problems that require technological solutions, and so on, ad infinitum. As Mokyr, who really isn't a technology uber-alles cheerleader, puts it: Technology isn't an undivided good. For every opportunity that technology creates, there are costs. Side effects, or bitebacks, happen and we need to find solutions, which are often other technologies, which create more bitebacks.

## For instance?

You just mentioned “fat and happy.” Well, for almost all of human history, famine was an ever-present threat. Now, we have the obesity “epidemic,” which is an unintended consequence of the agricultural revolution. We won the fight with hunger, so now we are fighting fat.

## And that's biteback that really bites!

Right, because fighting fatness is biologically harder than fighting hunger. We are conditioned by billions of years of evolution (not just our own species, but our ancient ancestors) to look for food and to gather and store extra food as a defense against hungry times. Combating obesity is, in contrast, a profound technological challenge involving diets, exercise regimens and medications that work against everything our bodies are telling us to do.

## I have to remember that line.

Seriously, we are just beginning to get a grip on these technologies. (We're not even sure if dieters should cut fats or carbohydrates.) These techniques will become an important component of global health and the economy.

Another major example of biteback is the environmental damage that has accompanied economic growth since the Industrial Revolution. Massive consumption of fossil fuels has raised justified concern about warming caused by greenhouse gases,

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primarily carbon dioxide. While there are only so many resources in the world, and the risks can't be eliminated, I think it should be possible to price those risks fairly, so the markets can allocate the right amounts of resources to alleviate each of them.

**Are you suggesting making it very expensive to create greenhouse gases? Carbon taxes and such?**

I'm in favor of setting a fair price; the current price, zero, is almost certainly too low. I don't have the knowledge to say what the right price is.

If the cost of emissions is set sufficiently high, it will stimulate technological advancement and the cost will come down, resolving the problem over time (although at a higher atmospheric CO2 concentration than before the industrial era started). But, I'm definitely not among those who would set the cost of emissions high enough to collapse the global standard of living, including the food supply. There is no reason to believe that such a high cost is needed to spur the required technological advances, and a radically high cost would probably make such advances unachievable.

Let me turn the table now and ask you a question. Are you familiar with Casey Mulligan's research on incentives to work?

**I don't think so.**

His most recent book was "The Redistribution Recession." He's a University of Chicago professor and he's basically arguing that people work when they have an incentive to work.

**That guy. The Wall Street Journal loved him. But his argument seems pretty self-evident.**

The argument is simple, but in practice there's a lot of resistance to it. For most jobs, for most people most of the time — maybe you and me excepted — work isn't all that much fun, so you have to pay people to do it. And it doesn't pay all that well, either.

Now, let's compare the incentives to work (mostly the paycheck) with the incentives that governments provide for not working. By making this comparison, I'm not suggesting we let people starve in the street; governments have a legitimate role in taking care of people who can't take care of themselves. But we've really pushed the envelope in redefining what that means.

**We clearly did, in the depths of the financial crisis. But some recent research — by the Chicago Fed, no less — says such "fiscal impetus" has recently been pulled back more sharply than after any previous downturns. [See Deep Dive.]**

I'm not questioning whether unemployment insurance provides some social good, as the study by Hsu, Matsa and Melzer argues. Of course it does. Labor markets are imperfect and it takes time to find a job; meanwhile, you have to eat, and if you don't default on your mortgage then everyone is better off. That's what Hsu et al. are saying. But there is also a very strong correlation between the length of unemployment benefits and the amount of time people take to find a job.

If you're deciding whether to work or not work, and unemployment or disability coverage is available as an option, you're going to be close to the margin when you make that decision — almost by definition. You wouldn't be considering the decision if you weren't close to the margin between the two.

However, as Stephen Sexauer of Allianz Global Investors has pointed out, you get off that margin pretty quickly. After you've been out of work for a while, it becomes unbearably costly to go back to work. Your skills have deteriorated, and you're competing with younger, more energetic people whose skills haven't deteriorated but in fact have improved. Meanwhile, you've learned to live on the level of benefits you're receiving, so the financial improvement from working becomes less important.

**So if a lot of people decide to collect benefits instead of working...**

Your productivity is then lost to the world forever. Even if you do eventually go back to work, what you didn't produce while you were out of work is lost to the world forever. And there's a multiplier effect. The money that you don't earn, you also don't spend, so other people can be thrown out of work by the fact that you (and other people) aren't working. Society can talk itself into a depression that way.

**You're forgetting that the person on disability will be spending his benefits — most likely all of them — and paying it forward that way. And that's not even getting into, perhaps, other social contributions of the sorts GDP doesn't capture.**

The benefit payments are not all that great, but you can learn to live on them. The difference between the size of the paycheck and the size of the benefit

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check is what's lost forever, and subject to a multiplier.

I'm not saying that we should just stop paying people not to work. I'm merely sketching out a natural consequence of extending that policy indefinitely: A work deflation spiral where everyone tries to live at the expense of everyone else, but their standard of living falls because fewer and fewer people are producing anything. People become satisfied with a lower standard of living, and that's how we talk ourselves into a completely unnecessary depression.

**Wow, Larry. I realize that's a reductio ad absurdum to make your point, but it implies an awfully grim take on humanity.**

Not really. People do the best they can with the hand they've been dealt. They weigh the rewards from one activity against the rewards from another. You know what happened to the Pilgrims.

**What part of the story?**

They seemed to be people of the highest character — they formed the Mayflower Compact for self-government that is the precursor to our own very successful constitutional system — yet they nearly starved because they had a communal arrangement for agriculture with no reward for individual effort. This arrangement was a good-hearted attempt to promote cooperation. But between food shortages, disease, and bad weather, half of them died between 1620 and 1623. When they adopted individual ownership of land and the fruits thereof, the community prospered. It's just human nature and we might as well get used to it.

**Agreed that communism isn't a good idea – how can we think about improving the quality of life for low-paid workers today, in the U.S.?**

The reality is that there is a skills mismatch. Employers are saying they can't hire people that don't fit the jobs that they have available, and the unemployed are saying that they can't get a job. I believe both of them.

But if you go into a Trader Joe's supermarket around here, you can see that they are finding good workers, just by paying well. At some price, and Trader Joe's seems to have found it at a little under \$20 an hour for seasoned staff, you get employees who show up for work. They're nice (sometimes so cheerful it's a little unnerving), they speak English, and they actually know something about the products that they're selling.

**Maybe you also have to spend a bit on training and retaining them.**

Of course. But you have to find the raw material. Trader Joe's system works well for them and for their workers and customers, because they're able to pluck off the best workers. But if everybody did it, you'd just be giving everyone a raise and getting nothing for it.

People really do vary in their ability. A worker whose skills are obsolete is easier to retrain than a worker who never had any. We no longer have a manufacturing base that requires massive amounts of unskilled labor, but we're not going to eliminate the bell curve: as Charles Murray reminds us in his book, "The Bell Curve," half of the population is below average.

**What are they going to do for a living in the new, technologically advanced economy?**

I don't know. It's a challenge. But it will be something. It's insulting to the human race to suggest that half of us can't do anything other than accept a handout. But statistically we seem to be getting there. I think that some of it is the result of bad policy, but some of it is just the result of a change in the nature of work.

Machines can now do things that persons with limited abilities used to do, and employers tend to prefer using machines. The U.S. actually has a vibrant manufacturing sector. We hit a new high in manufacturing output every year in real dollar terms. We just don't use nearly as many workers to do it as we did in 1970. We use a small number of highly-paid and highly-trained engineers and technicians. So manufacturing employment is way down while manufacturing output is way up, and we actually have a manufacturing boomlet. While more manufacturing jobs would be welcome, that would put even more stress on the market for \$80,000-to-\$150,000-a-year engineers, while doing little for the unskilled.

**No, for starters we need much better educational opportunities, all across the spectrum.**

I think the educational opportunities for the top 15% — what we call the good suburban schools — are good enough. Everybody else is in trouble.

I went to prep school in Ohio called Hawken, and it was a wonderful template for an educational system. Everybody should have the opportunity for

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that kind of educational experience. It was good enough that when I got to the University of Chicago as a freshman, the work was easy. I had already read Aristotle, Thucydides, Homer, and Shakespeare.

### **What about the people on the left side of the bell curve? Would you send them to Hawken?**

Not everybody can benefit from exactly that kind of schooling, but everybody can benefit from the level of individual attention, the dedication of the teachers, and the emphasis on building character. (Whoever thinks school budgets should be balanced by eliminating music, art, and sports should be tarred and feathered in the public square.) Ideally, a fully competitive market, with schooling publicly financed through vouchers but privately provided, would go a long way toward giving the Hawken experience to people who now cannot afford it or find a school that offers it. If you like this idea, the Friedman Foundation, founded by Milton Friedman, <http://www.edchoice.org>, supports this vision.

### **Great ideas for the long term. But how do we get out of this rut now?**

We can stop pouring SuperGlue over ourselves by believing in secular stagnation and acting accordingly, as if nothing we do will ever come to any good. If we start to believe in a positive-sum economy again, then people will do better in the long run. We will get the growth.

But it's hard to convince somebody who needs a job or housing or food in the short-run that their long-run interest is best served by staying in school. Or by taking a job that may not be the job that they ultimately want — because they'll learn something and it will lead to better things in the future. It's just hard to teach that kind of long-term thinking to people who have become convinced that they're victims of secular stagnation — that because everybody else got the goodies before them, they can't have any.

### **You're suggesting that the pundits should ditch their secular stagnation meme?**

Yes, and partly I blame your profession. Many economics reporters don't know any economics. They tend to believe what they were taught in college, which is that the economy is a scheme for taking from the poor and giving to the rich.

There are, of course, great exceptions. I am thinking of you and Jason Zweig and Jonathan

Clements. My apologies to any other reporters who are good economists whom I've left out. But I read an awful lot of journalism suggesting that people are being deprived of a chance in life by the fact that other people are doing well. That's just not the case. Success, like failure, tends to spread virally. But, when things don't go as you hoped for, there is a natural human desire to blame the other guy — to look around you and say, "Who did this to me?" and not, "What can I do to improve my situation?"

Playing the blame game is an instinctual response when something goes bad. I still think that Richard Koo's explanation of growth being held back, post-financial crisis, by a "balance sheet recession" makes a lot of sense. Except that by now the largest U.S. corporations should have repaired their balance sheets — and they're still not making long-term investments for growth.

I agree that we needed government financing to stabilize the financial system in the immediate aftermath of the crisis. That isn't stimulus, it's emergency funding to stop a bank run. (Whether the general economy needed ongoing stimulus after the worst of the financial crisis had passed is still an open question.) Where I part with Koo's analysis is that he treats the government as exogenous. Yes, we needed a rescue from somewhere but what he ignores is the fact that the government is us.

### **Not exactly. If I understand him, the government is exogenous in Koo's view only in the sense that it is the only one of the three economic sectors (consumers, business and government) that can make a collective decision to counteract the economic impact of all the individual decisions made in the other sectors.**

That's a valid point. Koo's basic notion of a balance sheet recession is right. If people try to save more at the same time as businesses try to save more and the government tries to save more — if every sector of society is curtailing its productive investments, its most valuable investments, because of the need to repair balance sheets — basically, because of the need to pay off old debts — then, yes, you can have a balance sheet recession. That is what the Great Recession was. Whether we are still in it, I'm not sure. We are no longer officially in a recession as defined by the NBER. But we are in a recession relative to the growth potential of the economy, and paying off debt is a plausible explanation. So I would recommend reading Koo as exemplifying one of many viewpoints.

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But at this point, U.S. corporate balance sheets are fine. In fact, they have more cash than they know what to do with — they don't have uses for the cash that they think will be profitable.

**Just how flush U.S. corporates are isn't clear. Andy Lapthorne contended in WOWS' last issue [9/12/14] that they only look to be rolling in dough because they've been taking advantage of bargain base-ment interest rates to pile on debt – which won't look nearly as manageable, should asset prices swoon.**

Yes, when companies can borrow at artificially low rates and what they do with it is just put the cash in a bank, or use it to buy back their own shares at inflated prices — instead of building a factory or a store or buying airplanes or trucks — that tells you that they've thought about their investment opportunities carefully and decided that cash in the bank is the best use for the money. That is a warning sign about the opportunities available in the economy, but cash is an option to spend later, and if you want to preserve that option, borrowing when interest rates are low is the way to do it.

**And if they're spending it like crazy on share buybacks to support the price of their shares?**

When asset prices are low, it's good; when asset prices are high it's bad. When companies would rather buy back their own stock at 20 or 30 times earnings than invest in productive capacity, they're seeing a bleak future. Again, it's a self-fulfilling prophecy.

**But are they seeing a bleak future – or simply opting for immediate gratification?**

That could be right, but if a company is holding cash, it's probably best to look at that as an option to buy something cheaper later. Some individuals are doing that, too — paying down their debt and accumulating cash because they think they're going to buy stock after the next crash. But crashes and bear markets aren't guaranteed, any more than bull markets are.

**People have seen a couple nasty ones in the last decade or so, so why not another?**

There could be another crash. I can't forecast the market. But if there is one, and if my growth forecast is even remotely correct, people who buy into the next crash will be very happy a few decades later when they begin to draw down their portfolio.

**Dollar-cost averaging can do wonders for long-term performance.**

Yes. People who sold near the bottom of the last crash and never got back in are panicking, because they think they'll never get to retire. But people who bought the stocks from them are very happy, and they're not saying much.. If you only listen to the squeaky wheel, you get a biased sample.

**Sure, but you know all the research. Most investors make nowhere near the returns funds advertise, because they buy at the tops and sell at the bottoms.**

Yes, I even did a study on that once. It's written up by Jason Zweig in his Money Magazine article, "What Fund Investors Really Need To Know," in June 2002.

But the target-date fund phenomenon — their increased prominence and popularity — has made this better. If people are just putting the same amount, every pay period, into a fixed-mix diversified fund — not fixed over decades, but fixed over any five-year period — they're going to get a rate of return closer to the market rate, and they'll get the benefits of rebalancing.

The whole retirement system is moving that direction, which in essence used to be the sole preserve of defined benefit pension plans. Defined benefit plans did well, historically, because they were professionally managed and they collected plan contributions relatively equally over time. In fact, when the market was up, they often had "contribution holidays" so they didn't have to buy stocks at the top. Then, when the market was down, they got higher required contributions, so they were able to dollar-cost average pretty effectively. And those plans usually did well.

**Too well, all too often, for their beneficiaries' own good, when managements started treating employee pension funds like honey pots.**

Yes, unfortunately the defined benefit plans became a cash cow for the corrupt. Too many managements shut them down to capture the gains. But now we've started to replicate their basic investment proposition in the target-date fund universe — albeit without the mortality risk sharing of DB plans — but that's a topic for another interview.

**How about the short course? Mortality risk sharing is not something to be sniffed at.**

No shit, Sherlock. It doubles or triples your income after age 85. If you could somehow find a deferred annuity that didn't have any credit risks — in other words, if you believe you will get your money — it would probably be the only investment that a per-

son over age 85 would want, because you're collecting from the people who don't survive. There's no such thing as a free lunch, but if you can contract to eat someone else's lunch, you're doing fine.

### Just try to find that annuity, though!

You can easily buy deferred annuities, but you can't buy one without credit risk. The question is what happens to your benefits when there's another financial system crisis.

### Precisely. I'll take that annuity without credit risk, thank you. So let's go back to something we might find first – growth.

We can get out of this stagnation. It's not secular! But we have to understand that getting out of it isn't automatic either. You don't pop back to that trend line by sitting there and waiting for the tooth fairy to show up riding a unicorn. We have to reform our educational system, we have to encourage companies to provide training, and we have to become more competitive in the global marketplace for goods, services, and labor. Finally, we have to make sure the rewards for creative thinking, entrepreneurship, and technological progress are equally available to all, without too much taxation or other interference.

Good thoughts all. Thanks, Larry.

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WellingWallSt. interviewee disclosure: Laurence B. Siegel is the Gary P. Brinson Director of Research at the Research Foundation of CFA Institute, and Senior Advisor at Ounavarra Capital LLC. Until July 2009 he was director of research in the Investment Division of the Ford Foundation, where he worked starting in 1994. Before that, he was a managing director of Ibbotson Associates, an investment consulting firm that he helped to establish in 1979. This interview is for purposes of intellectual stimulation and information only. Nothing in this interview should be interpreted as an offer to sell or a solicitation of an offer to buy a security, an interest in any fund, or make any specific investment at all. Mr. Siegel's views are exhaustively researched and based on information believed to be reliable, but are subject to change without notice. There are no guarantees in research, as in life. Nothing herein should be construed as specific investment advice.

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