September 5, 2014

"The worst evils mankind ever had to endure were inflicted by bad governments."

- Ludwig von Mises, economist

Brock Solid. In a world seemingly infatuated with the power of central bank printing presses, Woody Brock is a refreshing iconoclast. This is particularly true given his resoundingly upbeat message despite his criticisms of overreliance on monetary magic, or at least what looks like magic. Over the years, I've highlighted a number of Woody's insights and—during my "semi-sabbatical" in the summer of 2012—I even dedicated an EVA to his acclaimed book, *American Gridlock: Why the Left and Right Are Both Wrong*.

American Gridlock was Woody's valiant effort to get America back on its normal, healthy growth trajectory. Unfortunately, since that time, almost none of his well-conceived notions on reviving our economy have been implemented by our elected officials. Consequently, we are hearing more high-level commentary both here and abroad, of a condition often called "secular stagnation."

One of the most profound examples of that concession was a speech given last week by European Central Bank chief Mario Draghi, imploring EU governments to adopt reforms that sound like they came right out of *American Gridlock*. Shockingly, despite Draghi's popularity for his successful crusade (at least thus-far) to save the euro, he's publicly admitting the limitations of the printing press. (This week, Mr. Draghi literally went all-in to stop Europe's repetitive recession syndrome and intensifying flirtation with deflation. However, in my view, should its stultifying regulatory regime not be dramatically down-sized, the Continent will likely continue its long economic decay.)

Accordingly, I thought this was an opportune time to dedicate this month's guest EVA to a recent essay Woody wrote called "The Low Growth Hoax." As the title implies, he dismisses the defeatist acceptance of secular stagnation—popularized by former Treasury Secretary Larry Summer. Similarly, Brock shoots holes in Pimco's much-discussed "new normal" thesis that projects nearly perpetual economic underperformance for America.

Among Woody's many incisive points is that not all economic expansions are created equal. Specifically, if a nation's workforce is increasing by 2% and its productivity is flat, it will show a 2% GDP growth rate; however, its citizens will be no better off. On the other hand, a country whose labor force is unchanged but where productivity improves by 2%, will have the same overall growth rate but an actual improvement in living standards. This is why the recent contraction in productivity improvements is such an extreme problem for the US and must be effectively addressed.

As you will read, Woody outlines several solid solutions to overcome secular stagnation (SS) that are highly likely to be much more efficacious than manipulating interest rates and the money supply. Importantly, he cites seven real life case studies of countries that have implemented an ensemble of reforms which have re-ignited robust economic expansion. To those, I would also add the remarkable revivals that have occurred in Canada, Sweden, and Australia when they have "taken the cure."

There remains no doubt in my mind that America will eventually embrace the type of agenda for renewal that Woody is prescribing. Similarly, I am convinced our country will break out of the malaise it has been caught in over the past nearly fifteen years—ever since we began relying more and more on the Fed and less and less on creating an environment where innovation and entrepreneurialism are encouraged, not inhibited.

(The following is a condensed version of Woody Brock's July essay. For the full version, please click here . For an overview of his firm's superb research service, please click here.)

davidhaysig

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THE LOW GROWTH HOAX
Need We Accept Decades of Secular Stagnation? No. Low Growth is a Choice. Not a Fate.

By Woody Brock

"A West that prefers debt?subsidized welfarism over economic growth will not offer much of a model for countries in a hurry to modernize. A West that consistently sacrifices efficiency on the altars of regulation, litigation, and political consensus will lose the dynamism that makes the risks inherent in free societies seem worthwhile. A West that shrinks from maintaining global order because doing so is difficult or discomfiting will invite challenges from nimble adversaries willing to take geopolitical gambles."

-Bret Stephens, *Wall Street Journal*, June 2, 2014

INTRODUCTION

In this ambitious PROFILE, we take on the prevailing wisdom among macroeconomists that we have entered an age of "secular stagnation" (SS), a not?so?new concept that Lawrence Summers revitalized in his remarks to the IMF in a well?publicized November 2013 speech. Others who have approached the growth issue somewhat differently than Summers have arrived at similar conclusions, in particular Peter Berezin of the *Bank Credit Analyst*, Paul Krugman of Princeton University, Robert Gordon of Northwestern University, Mohamed El?Erian (the former head of PIMCO who coined the phrase "new normal"), and Martin Wolf of the *Financial Times*. When these commentators speak of low growth, they do not only refer to the US, but to the entire OECD group of nations.

We shall argue that, given a proper understanding of macroeconomic policy, all these commentators have largely misdiagnosed the growth story and are unduly pessimistic. Even more surprising, they have failed to stress that a *nation's growth rate is a choice —not a fate*. For example, had the right choice of policy instrument been utilized, much higher growth could have been achieved during the recovery of 2009–2015 than was achieved. Likewise, much higher growth could be achieved in the decades ahead than is now expected.

To be sure, Summers and his colleagues have offered specific policy recommendations for speeding up growth. But their proposals predictably center upon monetary policy—the only macroeconomic policy tool that anyone seems to discuss any more. The truth is that there islittle that the central banks can do to foster higher long?term growth. Attention must berefocused on other types of macroeconomic policies that *cause* economic agents to act in amanner that *causes* vigorous growth. The word "cause" is critical here. It is virtually never usedin today's policy discussions which are couched in terms of "correlations" or "associations"between various economic variables, e.g., as between interest rates, inflation, and growth.

In this essay, we shall identify growth?enhancing policies as part of the larger challenge of reconstructing macroeconomics as it was originally conceived, a reconstruction that highlights exactly what can be done to stimulate growth. Monetary policy will be seen to play a small role in this larger story.

Investor Implications: For investors, the issue of growth should be all?important. For bondholders, low growth is normally associated with low inflation and low nominal bond yields—but not always. For shareholders, low growth logically implies low earnings growth which is positively correlated with lower P/E ratios. For these amongst other reasons, an investor's forecast of future growth is all?important in determining an optimal asset allocation. But since growth is policy?contingent, as suggested above, the investor's true forecasting problem is that of updating his probabilities as to whether pro?growth or anti?growth policies will be implemented. At present, the latter case is much more probable than the former.

ECONOMIC GROWTH—SOME PRELIMINARIES

The Meaning of Economic Growth – Three Complementary Perspectives

GDP is the value of the total goods and services produced within an economy's borders during a year. There are three ways of understanding the growth of GDP that are useful for forecasting it.

The Four Components of GDP: The most familiar way of thinking about annual GDP *growth* is in terms of the percentage change of its four constituent parts: Consumption, Government Spending, Private Investment (housing and business), and Net Exports. By forecasting each of these changes measured as a percentage of GDP, the forecast growth rate of GDP will be the sum of these four changes. Of course, these component variables are interdependent, so it is not possible to simply arrive at an estimate of each of the four component changes independently. Much more analysis is necessary in order that the resulting forecast be internally consistent.

Workforce and Labor Productivity Growth: A second perspective is to utilize the fact that the percentage change in growth will be the sum of the percentage changes (i) in workforce growth and (ii) in labor productivity growth. This offers a completely different yet complementary approach to GDP forecasting, especially over the long run where demographic and productivity trends can be much better analyzed than in the short term. Also, trends in workforce growth and in productivity growth are two variables that are totally independent of each other. This simplifies forecasting as each can be analyzed on its own.

National Income: A third perspective stems from recalling that GDP roughly equals National Income. The latter consists of the sum of (i) all "rents" to capital of all kinds (profits, interest, dividends, rent, and whatever), and of (ii) all wages and salaries paid to managers and workers.

National Income analysis is not particularly useful for forecasting GDP proper. An investor cannot simply forecast changes in total labor income and total rents out of the blue. A proper GDP forecast is required. What a National Income perspective does make possible is a better understanding of future changes in the split of GDP into its profits?versus?wages shares. This is not a topic we shall pursue, having done so several months ago in our October 2013 PROFILE, "Labor’s Falling Share of National Income."

Complementarity of the Three Perspectives: When analyzing GDP growth, it is useful to take into account the interdependencies that exist between these three perspectives on growth. For example, suppose that you come to believe that labor’s share of National Income will shrink and capital’s share will rise. Suppose independently that you expect the owners of capital to confront low returns from productively investing their growing share of income—the case in the West today where business investment has been low virtually everywhere.

Then these suppositions pose two threats to GDP growth. First, corporate investment will be low. Second, consumption will be lackluster because of stagnant incomes. As a result, GDP growth will be sluggish since changes in both investment and in consumption are, by definition, components of changes in GDP growth. Many other examples could be given of the ways in which the insights from thinking about growth in different ways are complementary, and help to arrive at a sound forecast of growth.

THE IMPORTANCE OF GROWTH--ESPECIALLY DURING THE NEXT FEW DECADES

Growth is considered to be the most important variable in economics. It is the celebrated rising tide that lifts all ships. The stronger the growth for a cluster of nations, the less incentive they have to go to war; the higher are the living standards of their people, the less likely they are to run public sector debts; the more the stock and bond markets favor them; the greater the ability of governments to fund productive national investments, to take better care of the sick and elderly, and so forth.

Many assume that strong growth imparts an inflationary bias to an economy. But this is not the case in practice. One reason why is that, when economic growth is strong, productivity growth is often also strong. And rising productivity lowers unit labor costs in a way that renders growth non?inflationary. Of course, this is not always true since there are types of inflation that do not center upon growth and productivity, e.g., the wage?price spirals that drove US inflation to over 14% in the late 1970s despite modest growth.

But economic growth results in more than greater efficiency and rising living standards. It is good for environmental consciousness, for reducing and coping with poverty, and for those moral aspects of our lives. This latter point was stressed by Professor Benjamin Friedman of Harvard in his important 2005 book *The Moral Case for Economic Growth*. One way to appreciate this is to think of economic life prior to the seventeenth century as a zero?sum game. Most rulers could only enrich their people by seizing the land and resources of the kingdoms nearby. What ruler A and his people gained, ruler B lost. And often both lost due to those wars that resulted, wars that transformed a zero?sum game into a negative?sum game.

The advent in Northern Europe of such advances as patent protection laws, the specialization of labor, the rule of law, greater trade, and positive productivity growth changed everything. It would be learned over the next three centuries that the citizens of most any nation could become winners?from?growth. These advances transformed a zero?sum game into a positive?sum game in which individuals and nations could help each other while they helped themselves. This development profoundly impacted our moral perspective and in turn our behavior.

Good Growth, and the Growth Paradox whereby [2% + 0%] < [0% + 2%]: Since GDP growth is the sum of workforce growth and labor productivity growth, then economy A with a 2% workforce growth along with 0% productivity growth should yield the same GDP growth as economy B does with a 0% workforce growth along with a 2% productivity growth. It does, numerically, but that is not the whole story. In case A, living standards will not rise at all, implying citizen unrest and possibly political turmoil. This is not true in the second case where the dream of a "better tomorrow" is real, and citizens are happy campers.

In this regard, rising productivity and living standards have played an important role in sustaining many democracies. We shall thus speak of 0% + 2% as "good growth," since productivity growth is strongly positive. But 2% + 0% growth is "bad growth." It usually gives rise to greater sovereign debt and higher unemployment, and to the election of populist strongmen who ultimately undermine democracy. It is for this reason that economists pay such attention to productivity growth: the ability to get more with less via (i) more capital invested per worker, and (ii) "learning by doing" which permits workers to make widgets more efficiently *without* any more capital—true innovation.

Extreme Importance of Growth Tomorrow: If growth has always been important for the reasons given above, it will be far more important than ever before during the next thirty years. This is because growth will be the best way to cope with a pending retirement spending crisis that is unique in modern history. When the growing number of elderly is combined with a fertility rate that will have fallen from 5 to 1.3 in many countries over the past century, the "dependency ratio" of workers?per?retiree will implode from as high as 6?to?1 before to as low as 1?to?1. What does this imply? The answer: unfunded liabilities.

The unfunded liabilities in the US for medical and retirement care total $60 trillion, according to the CBO. If we include Japan and Europe together with the US, this number could approach an OECD total of $140 trillion or even higher. These figures represent the shortfall of currently projected tax revenue to cover spending "promises" already made to the elderly for the period 2015–2050. This development is completely new in history, and strong growth is far the best way to cope with such a crisis. In this respect, the response of tax revenues to higher growth is twice as great as most economists imply. Just consider their failure to foresee the huge improvement in the US budget deficit from increased tax revenues during the recovery period 2011–2015. The deficit as a share of GDP will have fallen from 10.2% to 3.5% over that five?year period. Once again, growth proves to be the rising tide that lifts all ships.

THE "SECULAR STAGNATION" (SS) HYPOTHESIS – ITS STRENGTHS AND WEAKNESSES

Our criticism of the SS hypothesis is not based upon what its adherents claim. For in so far as they go, they advance compelling reasons to expect sluggish growth. *Our concern rather stems from what they have not written about the true sources of growth*. As a consequence of ignoring these sources, they have failed to identify and champion the very policies that are now needed. While consensus economists now emphasize the headwinds to growth, we shall emphasize the tailwinds. It will be seen that the extremely narrow scope of pro?growth policies proposed by the SS camp is highly irresponsible since both economic theory and empirical evidence make crystal clear how to boost growth in difficult times.

CRITICISM OF THE SECULAR STAGNATION HYPOTHESIS

Here are some counter?arguments to the four developments discussed above arguments suggesting that stagnation is not inevitable. All of these are "weak" compared to those set forth in the upcoming section on "Seven Great Growth Turn-Arounds."

1. Fallacies about Household and Government Indebtedness: In the US (more than in Europe) deleveraging is well under way both in households and in government. More specifically, the rate of the increase in private and public debt has dropped. There is no reason that deleveraging as usually defined should not have run its course within five years. If this happens, then deleveraging need not hamper long?run growth in the future.

2. Fallacies about Adverse Demography: In an excellent recent article "The Fear Factor" in *The American Scholar* (June 2014), Lincoln Caplan of the Yale Law School attacks the entire "dependency ratio" story. He draws on new research carried out at several universities revealing the growing ability of people to stay in the workforce much longer than is commonly assumed, and longer than they have in the past. The most important reasons why are (i) health expectancy has risen even more than life expectancy, (ii) life expectancy itself continues to lengthen, and (iii) the physical demands of work are falling. Additionally, the need to prolong working lives is pronounced given the low level of savings of most retiring Americans, and given the relatively small size of Social Security payments. Thus, the predicted slowdown in the growth of the workforce is much exaggerated.

Additionally, policy reforms such as labor market deregulation throughout Europe could significantly lower the structural unemployment rate over time. This would add millions of new workers to the workforce at the same time that demographic developments were shrinking it. Finally, in Japan, Prime Minister Abe has proposed to redress workforce shrinkage by policies that induce more women to join the workforce. All such developments suggest that the assumed role of demographic factors in reducing future workforce growth is overblown, at least in nations that adopt sensible labor?augmenting policies.

3. Fallacies about High Real Interest Rates: In the column cited above, Professor Taylor of Stanford University debunks Lawrence Summers' theory about inadequately low real interest rates. "First, this argument implies that there should have been slack economic conditions and high unemployment in the five years before the crisis, even with very low interest rates—especially in 2003–2005... But it was just the opposite. Boom?like conditions prevailed...The unemployment rate got as low as 4.4%, well below the normal rate and hardly a sign of slack."

Taylor claims that factors other than real interest rates explain today's lack of investment on Main Street, and the depressed demand for credit. "Business firms have continued to be reluctant to invest and to hire, and the ratio of investment to GDP is still well below normal. That is most likely explained by policy uncertainty and increased regulation, including the Dodd?Frank and Affordable Care Acts in the US."

Taylor concludes with the following interesting speculation: *"The secular stagnation hypothesis shouldn't be surprising. As long as there is a demand (need) to pin the failure of bad government policies on the market system or on exogenous factors, there will be a supply of such theories."*

We would go way beyond Taylor in criticizing high real rates as the principal cause of low growth in the future. To begin with, the very idea of an "equilibrium" interest rate as the rate "consistent with full employment" strikes us as badly confused. The claim is that, with suitably low real interest rates, an economy will obediently generate full employment. This is preposterous. Consider Southern Europe's lackluster growth for decades. Does anyone believe there exists any "equilibrium" interest rate that would generate full employment without a thoroughgoing deregulation of product and labor markets? Would a ?50% interest rate do the trick? ?80%?

The truth is that, when growth needs to be rekindled as it does in the West, many policy variables are called for that are far more effective than adjusting the level of real interest rates.

Indeed, changes in real yields can be shown to correlate little if at all with strong spurts of growth in the past. It is very odd to us that Professor Summers has made the real interest rate issue a centerpiece of his prognosis of SS. Of course, he is aware that more is needed, and in a recent article on how to kick?start growth, he does cite the need for "greater investment spending" in the public sector of the US. But this appears as an afterthought, and with no call for what the US really needs: a public sector Marshall Plan of some $10 trillion to repair the depreciation of our infrastructure over the past fifty years when infrastructure investment net of depreciation was negative almost every year.[1]

[1]See "What the World Must Do to Kick?Start Growth," by Lawrence Summers, *Financial Times* Op?Ed piece, April 6, 2014. As for Europe, he proposes "a banking system that can be a conduit for a robust flow of capital." He says not a word about the long?required deregulation of product and labor markets. Such is macroeconomics today.

4. Fallacies about Labor Productivity Growth: There are three fallacies. First, economists do not understand the nature or causes of productivity growth, and they admit it. To begin with, there is the widespread fallacy that productivity correlates highly with the rate of innovation. This is often not the case, as is true at present. Indeed, what is required for higher productivity growth is not merely innovation, but the widespread dissemination of innovative tools and processes. But the nature of such dissemination is not well understood. For this and other reasons, economists have had a very poor track record of explaining much less predicting productivity growth. Pay no attention to their forecasts of this variable!

Second, it is strange the SS adherents choose to extrapolate into the long?run future the low productivity growth of 1.6% during the past five years. What does this abnormally low rate have to do with the long run? Not much is the answer. To begin with, while economists complain that there has been a sharp secular decline in productivity growth over the past six decades, the data do not support their view, at least in the case of the US. In the supposedly golden era of 1950–1979, productivity growth as measured by the BLS (non?farm business sector growth per hour) was 2.5%. In the subsequent period of 1980–2013 it fell to 2.0%. If, as seems reasonable, we adopt an arithmetic average of these two numbers as a long?run forecast, namely 2.25%, then the drag of reduced labor productivity growth on future GDP growth becomes insignificant.

Third and finally, there is an increasing awareness that economists are very poor at measuring productivity growth. Today’s government statistics probably underestimate it by at least 1% and thus also exaggerate inflation by 1%. Let us give a concrete example of this reality. The author just bought a new Evinrude 150 HP outboard engine to replace an identical Evinrude motor twenty?three years old. The price for the new engine was unchanged in real dollars, using government statistics. But the new motor’s consumption of oil and gas is 50% lower, the noise level is 75% lower, and reliability is at least double.

Similar quality improvements are found in cars, medicines, consumer electronics, and many "services." The US government’s attempt to capture such improvements via so?called hedonic inflation adjustments may only scratch the surface of what is needed. Many other nations do not even make such adjustments at all. Were these quality improvements properly measured and reflected in lower?than?reported inflation, we suspect that people would be found to live much better today than they did several decades ago, despite the widespread belief that living standards have stagnated since 1975.

Conclusion to this section: Attacking the SS hypothesis in the manner we just have is easy since its limitations are quite obvious. But attacking SS is not the same as prescribing what should be done to promote significantly faster growth than is expected—the more challenging task. To do this, we must adopt policies that far transcend those bromides outlined above. We must go much deeper and think well outside the Box. We now do so in the following section.

SEVEN GREAT GROWTH TURN-AROUNDS OF HISTORY

Some twenty years after Keynes, Robert Solow of MIT and several others developed the theory of economic growth. Growth theory was developed largely independently of "standard" fiscal and monetary macroeconomics. Nonetheless, it was acknowledged from the start that, just as well?functioning micro?markets presuppose good government policies (e.g., enforcement of the rule of law, of competitiveness, and of property rights), so does optimal growth. Yet the issue of government policies that are growth?maximizing never became central to macroeconomics as it is taught or discussed by pundits.[2]

[2] One reason why is that the foundations of formal growth theory rested upon the abstract concept of a nation's "production function," a concept that does not naturally suggest pro?growth policies.

We now demonstrate how to reunify macroeconomics, incorporating growth theory within it. In doing so, we identify the kinds of policies needed to rekindle growth, partly because the West cannot afford decades of stagnation, and partly because macroeconomics should deal with these policy issues. The new Econ 101 of tomorrow should deal with monetary, fiscal, and growth policies in a unified manner.

Consider the following extraordinary real?world case studies where nations experiencing very low (sometimes negative) growth suddenly change course and grow rapidly. Then ask, "What did the trick in each case?" It was almost never a change in fiscal or monetary policy.

1. Northern Europe Pre? and Post?Industrial Revolution circa 1700–1850: The growth in productivity is estimated to have been zero, on average, in the period 1000 BC to 1700 AD. Productivity growth did not increase, nor did living standards, nor did life expectancy. This continued to be the case worldwide after 1700, except in Northwestern Europe where the Dutch Republic and England (after its Glorious Revolution of 1688) adopted new policies including patent protection, the rule of law, respect of property rights, and so forth. Nations that did not follow suit stagnated.

2. China Pre? and Post?1979: Growth during the Cultural Revolution was negative. It then exploded to over 10% for twenty years. Why this reversal? It was largely because entrepreneurial behavior was de?criminalized. Recall Premier Deng's legendary mandate, "It is now glorious to go get rich." Additionally, the government adopted a massive infrastructure plan that represented productive investment spending in contrast to the unproductive spending that occurred during 2008–2012 ("see?through cities").

3. The Contrasting Growth Stories of North versus South Korea 1955–2010: Here we have perhaps the most significant case study in history about what works in generating growth, what doesn't work, and why. Two nations with citizens of identical blood and cultural background were governed by rulers with two very different ideological perspectives on economics. According to UN statistics based upon North Korea's own problematic data, annual growth averaged 0% between 1980–2010. [More informed estimates place growth around –1%.] In the South, growth averaged 8%. During this period, cannibalism appeared for the first time in North Korea. Need anything further be noted?

4. Ireland Pre? and Post?1980: We all know that, for centuries, the Irish were depressed, drunken, and unproductive—losers in short. But during the first half of the 1980s, policy changes were introduced that transformed these losers into winners who, by saving, investing, and working, could dream of a better future and indeed achieve it. Ireland became a case study of what to do to greatly increase growth and living standards. [The fact that the Irish banks subsequently enabled the same kind of housing bubble that the US experienced is irrelevant here as it occurred later than the 1980–2000 period under discussion.]

5. Germany Pre? and Post?1993: *The Economist* magazine dubbed Germany "the Sick Man of Europe" in 1990. It had no trade surplus to speak of. The Germans weren't supermen after all. Of course, Germany had shared with almost every other European OECD nation the malaise of Eurosclerosis. But the German government had a special challenge after 1990: rebuilding and incorporating East Germany into West Germany. Gerhard Schröder faced the realities of what was wrong—in particular regulated labor markets—and began to deregulate these around 1993. Despite only partial deregulation of the labor markets, and little if any deregulation of product markets (rules as to when shops can stay open, etc.), Germany emerged as the Strong Man of Europe over the next twenty years. Its growth in unit labor costs flattened out famously, whereas those of its European sister nations did not since they did not deregulate their markets. As a result, Germany’s trade surplus swelled and its unemployment level dropped.

6. US Pre? and Post?1982: The US economy was an embarrassment under President Carter. After President Reagan was elected, and after Fed Chairman Volcker drove down US inflation during 1980–1983, the US took off and would emerge by the Millennium as first and foremost of all economic powers. It possessed textbook?perfect unemployment, good productivity growth, a trade surplus, a fiscal surplus, and unsurpassed levels of innovation. Its Japanese rival, the Rising Sun, collapsed around 1990 due to a speculative real estate bubble not very dissimilar to the one that would bring down the US in 2008. Reagan kick?started all this by deregulating the economy in many different ways, and also boosted military investment and stood up to the Russians. Like him or hate him, his policies worked well.[3]

3Deregulation was needed throughout the real economy. But where Reagan and subsequently Clinton and Greenspan went wrong was to suppose that the financial markets should also be deregulated as if they were simply "other markets." Even Adam Smith discussed the fundamental difference between Main Street and Wall Street in this regard, stressing that the financial sector must be regulated.

7. UK Pre? and Post?1980: The UK was an embarrassing basket case by the time of the election of Lady Thatcher. Her grit in seeing through an ambitious and successful programme of deregulation is now legendary—hate her, or like her. Other such case studies abound—Poland and Singapore and Hong Kong for example. During 1960–2010, Hong Kong developed from a rocky resource?poor promontory to a land of great riches, while Singapore was transformed from a malarial swamp into a stunning success.

WHAT THESE TURN-AROUNDS HAVE IN COMMON: INCENTIVE STRUCTURE REFORMS

Tautologically, the economic growth rate of a nation measures its growth in economic activity. Economic activity in turn is driven almost exclusively by what individual economic agents are motivated to do and are able to do when they wake up every day. If a South Korean named Mr. Li has an idea to start a company, he is motivated to do so since he is able to get a loan (or seed capital), since he knows he can get rich if he succeeds, and since he knows he will gain great honors if his business is an international success. His identical North Korean twin three miles to the North knows that, if he starts a similar business as he would like to, his reward will be to have his fingernails and toenails pulled out. Alternatively, his government could simply steal his business, his ideas, whatever, and then enslave him in a labor camp. In both cases, incentives cause the behavior which causes high/low growth respectively. Indeed, growth is the result of millions of citizens like Mr. Li who are incentivized to enter into growth?generating activities of all kinds.

In every case study presented above, reforms to the incentive structure played the key role in generating enduring growth.Policies were adopted that made it rational for citizens to undertake more and more of those activities that generate growth. Product and labor markets were deregulated, taxes were often lowered or at least rationalized, the rule of law was implemented (where lacking), the level of judicial corruption fell, profitable as opposed to unprofitable investment was undertaken, cronyism was discouraged, and so on. These policy changes altered the incentive structure in ways that promoted growth?enhancing activities by individuals. Growth, in this sense, is bottom?up, not top?down.

SURPRISING IRRELEVANCE OF FISCAL AND MONETARY POLICY

Were any of these success stories generated by "optimal" monetary and fiscal policy? No. To state this differently, could a proposal by the central bank to lower or raise rates by 50 bp (Raise rates! God forbid—what would "the market" think?) have made a whit of difference in the success stories we have detailed? No. And would Quantitative Easing have made a whit of difference? No. What about altering "equilibrium" real interest rates via appropriate forward guidance strategies, whatever these are? Would this have materially boosted growth? No. Is this what has mattered in Singapore and Hong Kong? No. No. No. No.

No, macroeconomic strategies of the kind we read about today are almost completely irrelevant to stimulating long?term growth, and that is what the SS hypothesis is all about. It is a long?run story, not a short?run stabilization story. And a macroeconomics devoid of incentive structure logic is all but useless in prescribing remedies for economic stagnation.

This is not to say that fiscal and monetary policies are totally irrelevant, as they are not. But their principal role, as Keynes stressed, has been to stabilize the business cycle when cycles occur, or else to manage bouts of high inflation. For example, in the early Reagan years, monetary policy culminating in a 1981 Fed Funds rate of 23% under Fed Chairman Volcker was very important. Policies were needed to bring about a recession that would drive CPI inflation way back down from its unprecedented 1981 peak of 14.2%. Volcker succeeded.

We shall now take the above logic of economic growth and show how it can be incorporated into macroeconomic theory proper. This will conclude the essay.

CONCLUSION—STIMULATING OECD GROWTH TODAY

By reinterpreting macroeconomics as offering far more than fiscal and monetary policy, it becomes clear how much better off we could be if government optimized not only across fiscal and monetary policy, but across growth policy as well. By their very nature, growth?maximizing policies require that we confront the all?important issue of incentives, and even of incentive structure compatibility. Contemporary macroeconomics completely sidesteps these issues as our analysis of secular stagnation showed. According to both data (the seven case studies we cited) and theory (Hurwicz’s analysis), it is likely that long?term growth could be doubled in most flagging OECD economies. Macro?controllability would also be achieved since many more policy tools would be used to satisfy many more goals. Let’s consider applications of this simple logic to the US, Japan, and Europe.

Case of the US: Lawrence Summers is right in his recent call for public sector investment on a much larger scale than we have seen. Yet even here his concern is to get the economy moving in the shorter term, and he rarely discusses how to boost long?term growth. Yet Philip K. Howard does address this issue in his brilliant new 2014 book The Rule of Nobody. Howard is a lawyer, not an economist.

Without knowing it, he draws upon incentive structure logic to argue along legal lines that the major inhibitor to growth here in the US is the never?ending growth of excessive and contradictory regulation. Laws never sunset. They just multiply. They become the crabgrass that blunts the lawnmower.

The Federal Register (and state/local analogues) becomes longer and longer. Individuals have less and less scope for human judgment in determining what is best in building a business, acting as a governor, or whatever. Instead of focusing on optimal performance, they focus increasingly on not breaking some law or regulation. They become risk averse rather than entrepreneurial. The statutes making possible Social Security, Medicare, and the Interstate Highway System were short and direct—often 30?50 pages in length. Now their equivalents require thousands of pages of law that no one can understand. But woe to those who are sued for violating these provisos!

Efforts that might be directed towards enterprise creation become redirected towards obtaining ever more "permits" and "clearances." In New York City, it took two permits to open a restaurant in 1960. Now it requires at least twelve, and it takes tens if not hundreds of thousands of dollars to do so over periods of up to three years. Does this incentivize entrepreneurs to open such businesses? The reason why Silicon Valley works so well and witnesses so many start?ups is that it is unregulated. There is little crabgrass—so far. But just wait.

Note the irony of Howard’s thesis: The Rule of Too?Many?Laws that is now undermining our economy, just as the Rule of Basic Law once underpinned our success.

Between entitlement reform, regulatory reform (of the kind Howard proposes), tax reform, and a Marshall plan for infrastructure spending, the US could raise its long?term growth rate by at least 1.5%. That is our belief.

Japan: Prime Minister Abe originally spoke of his "three arrow" strategy. The third arrow consisted of "structural reforms," in particular reforms to Japan’s infamous business and labor cartels. He stated that such reforms were far more important than fiscal and monetary reforms if Japan is to regain suitable long?term growth. In our terminology, structural reforms of this kind amount to incentive structure reforms that cause people to act differently and more productively. With suitable reforms, including the encouragement of women to work, Japan’s growth could be double or even triple what it was during 1990–2010.

Europe: The roots of Eurosclerosis have been analyzed from many perspectives. Our own favorite analysis was that of the McKinsey Global Institute inaugurated in the 1990s. Their conclusion: the growth rate of Europe could nearly double simply by significantly deregulating Europe’s product and labor markets. The incentive structure in place all but guarantees stagnant long?term growth and high unemployment. In particular, it violates the Fundamental Theorem of Labor Economics:

"It is irrational for me to hire you if I know I can never fire you."

Many politicians cop?out of undertaking serious reforms, claiming that "product/labor market deregulation and entitlement reforms are politically sensitive issues we dare not touch." In doing so, they are in effect choosing low growth and high unemployment for future generations. *Low growth is a choice, not a fate*. This has been the main point of this essay.

Important Disclosures

recommendations of particular securities, financial instruments or strategies to particular clients. Investors must make their own investment decisions based on their financial situations and investment objectives.