4711 - Session V Bruce Greenwald

[Start of recorded material at 00:00:00]

Professor Mitts: All right. So as I talk, the folks in the hallway will start coming in. All right.

Edmund: They'll hear your voice, Bruce.

Bruce: I hope so. All right.

Professor Mitts: Great. So My name is Professor Mitts. I am a second-year professor here at Columbia Law School, and I have the great pleasure of introducing our next two speakers. Bruce Greenwald is going to begin – holds the Robert Heilbrunn Professorship of Finance and Asset Management at none other than Columbia Business School, just across Amsterdam, and is the academic director of the Heilbrunn Center for Graham & Dodd Investing.

Described by the New York Times as a guru to Wall Street's gurus, Greenwald is an authority on value investing with additional expertise in productivity and the economics of information. Greenwald has been recognized for his outstanding teaching abilities as the recipient of numerous awards, including the Columbia University Presidential Teaching Award, which honors the best of Columbia's teachers for maintaining the university's longstanding reputation for educational excellence.

His classes are consistently oversubscribed, with more than 650 business school students – and non-business school students, I imagine – taking his course every year in subjects such as value investing, the economics of strategic behavior, the globalization of markets, and the strategic management of media.

Next we're going to hear from Edmund "Ned" Phelps, the McVickar professor of political economy and the director of the Center on Capitalism and Society here at Columbia. Professor Phelps was the winner of the 2006 Nobel Prize in Economics; the director, as I said, of the Center on Capitalism and Society here at Columbia. There's so much I could say from his biography, but I'll just point out a few facts.

He's written books on growth, unemployment theory, recessions, stagnations, inclusion, rewarding work, dynamism, indigenous innovation in a good economy. His work can be seen as a lifelong project to put people as we know them into economic theory. Now he's worked to put economics on a new foundation.

Powerful innovation over more than a century alters the nature of the advanced economies. Having higher income or wealth matters less, as his book, "Rewarding Work" begins to argue. What matters more are nonmaterial rewards of work, being engaged in projects, the delight of succeeding at something, and the experience of flourishing on an unfolding voyage. His book, "Mass Flourishing," remarks that cavemen had the ability to imagine new things and the zeal to create them; but a culture liberating and inspiring the dynamism is necessary to ignite a passion for the new.

It's hard to think of a more, I think, fitting end to our day than this perspective that we're going to hear now. So I'm going to turn it over to Bruce to get us started.

Bruce: Okay, so this is a session where I'm going to respond to something that Mark Rowe said; which is, something else is going on, and I'm going to tell you what it is. So what we're going to do is talk about globalization – I mean, I'm sorry, corporate governance – in the context both of the global circumstances that you see and in historical context. So I think you'll get a sense of the limits of corporate governance in the face of what's going on.

What I think is clear – and I've just come back from living in Paris for four months and visiting Japan for the first time – is, the unhappiness with economic performance is global; that whether it's Europe, whether it's Southern Europe, whether it's Japan for the last 25 years, or whether it's the United States, there is a widespread sense that the economy is not working well, as I say; and also even in China these days, there seem to be emerging tensions.

That tells you something very important about the role of corporate governance. Structural, technological, economic change tends to be global; and corporate arrangements tend to be local or national. That in itself argues against the notion that you're going to solve this global problem with a local solution. So I'm going to really say, corporate governance is not the problem here. The problem is a global economic transition, and to the extent that you try and fool with corporate governance, especially across cultural regimes where different governance regimes work with different effectiveness in different social contexts, you're much more likely to hurt things than to help things. There are other things in this transition, other interventions, that are going to do a lot better.

So from the point of view of the topic of this conference, counternarratives on being obedient to authority – which is not what I'm good at as a rule; but on the other hand in the context of taking corporate governance seriously – this talk is going to be a downer.

All right, so what I want to start talking about is economic dislocations. This is the history. If you're a Keynesian, there are two enormous problems with Keynesian theory; which is still a persistent part of diagnosis of international problems. The first is that it is not a cyclical theory. Keynes does not have a theory of economic recovery. He has a theory of economic movement and animal spirits as sort of his account of how you get out of a recession. The reality is that recessions are self-correcting almost all the time. You have a six to nine-month down cycle, and then a long, slow recovery; and the consequences tend to be relatively limited.

On the other hand, there are occasions where it's not self-correcting, where the consequences are extended over a long period of time, where things are very bad. Obviously what I'm talking about here is the depression, and it's got very bad consequences. What I'm going to try and tell you is that we are in one of those second situations.

To give you just some background on this, when this sort of thing happens, typically forecasting models break down. They have obviously broken down. This is the Fed's forecasting model. That bottom solid line is what actually happened. Those upper lines are their forecast of what was going to happen. They're consistently over optimistic, and they don't adjust. There are things going on that Mark Rowe can't [unintelligible 00:07:21] identify, and it's absolutely clear that policymakers and monetary authorities and fiscal authorities around the world have not been successful in identifying. This picture, by the way, doesn't get better.

Again, typical business cycles start with a demand shock. Companies are surprised by the level of demand. They accumulate inventory and capacity. They can't finance it with equities, so their balance sheets deteriorate. They accumulate debt, and at a certain point they decide, we have to fix our balance sheets; because the risks of carrying those balance sheets in the face of economic uncertainty becomes too high. You get a short, sharp contraction. By the way, the fluctuations in output are greater than the fluctuations in demand for exactly this reason: that they reduce production and reduce inventory; they reduce investment; cashflow improves.

Over time that restores the balance sheet. Their willingness or ability to accept risk increases, and you get a long expansion until they overdo it, which is sort of the Minsky story; and there's an informational story for that. Ultimately the crucial problem here is that when there is a negative surprise, informational considerations prevent firms from financing that surprise and smoothing it out through financial markets. They have to adjust their real operations, and that has negative consequences.

On the other hand, the depression looks nothing like this. That second half of 1929 is bad. 1930 is worse. 1931 is terrible. 1932 is bad, and early 1933 is bad. This is not a short, sharp contraction. This is a continuous contraction and a relatively slow recovery. In certain cases like Argentina, like Uruguay, to a certain extent Mexico, countries do not recover from the depression. Argentina, for example, is a fully developed economy through the 1920s. After the depression it never catches up with the north.

The current recession, I should be clear, looks a lot like that. It has very long life consequences. In Japan we're talking about 25 years. In Greece and Italy, actual levels of per capita income are below what they were pre 2008, and they're now many years after that. It looks like, if you want to come to terms with what's going on, you have to think about what it is that caused these long cycles and what it is in terms of the depression and, increasingly, what it is today.

The depression and all these cycles look – and by the way, I'm not going to take credit for this work completely, although all the faults are mine. This is joint work with Joe Stiglitz, which is another thing that I do with my time. All these cycles seem to be associated with large, important sectors collapsing. They don't collapse for anybody's bad actions. In the depression it's agriculture. The reason it collapses is, productivity grows this three to five percent a year, and global demand growth is one to two percent a year, and that industry is going to die. You've got to move the people out of it into the replacement sectors, and that process is not an easy process.

So what happens is that actually pre 1920, agricultural incomes were pretty high. When you get the recession in '21, '22, therefore, farms [can 00:11:18] with good, strong balance sheets – you see a lot of outmigration from the farm sector. Over the '20s those balance sheets deteriorate, so when things go bad in 1920 – and this was something we looked for and were actually surprised to find, because as theorists we don't typically make successful empirical projections.

Outmigration from the farms collapses. It goes to zero, and it's because they can't afford to move. They stay there. Productivity continues to grow. They continue to produce. Demand has been elastic, so prices continue to fall. They're further impoverished, and between 1929 and 1933, agricultural incomes in the United States decline by 80 percent. When that happens of course, and you've got a third of the economies in those communities, it brings the rest of the economy down with it; because the demand just goes away. Even if you could move off the land, you're not going to get the jobs.

That happens globally, and you get a phenomenon that you see today; which is, countries try and export their way out of the problem. So I don't think it's an accident that, when we talk about trade wars today, we're talking about it in the context of trade wars in a depression. Argentina and Australia devalue very early on. Everybody is trying to export, and in the short term you can do that. The problem is, when you add up over all countries on this planet, the agricultural exports and the agricultural imports have to sum to zero. So you can't get out of the problem by exporting; and as you try to export, you exert continuous deflationary pressure.

Now this is the other great shortcoming of Keynesian economics. The story that gets told is that it is the war that solves this problem of aggregate demand. What all the Keynesians have forgotten is that they were all running around Washington in 1944 and 1945 saying, quite properly, if you're a good Keynesian, the depression is coming back once all this war production goes away; and it didn't except, as I say, in these countries that didn't participate in the war.

I think the answer to that is that the war is inadvertently extraordinarily successful industrial policy. It moves everybody off the farms, either through the Army into these urban industrial markets and industrial supporting services or just directly into the war plant. So the problem of financing the agricultural outmigration goes away; and by the way, it goes away all over the world. Reconstruction is a big source of the movement of people off farms.

That's a transition where, actually, the endpoint of the transition is extremely attractive. Industrial institutions are big, concentrated institutions. That means you can put a lot of management attention on them, and really progress is much more related to technology diffusion than technology creation. You see, in the wake of the war and in the wake of this transformation, an extraordinary burst of productivity growth around the world. The countries that are eviscerated, and countries like the United States that are not affected by the war have this extraordinary progress that takes place; as opposed to agriculture, which is decentralized, where it's much harder to diffuse innovations.

The second good thing that happens about this is: When you work in industrial establishments, you work collectively. When you work collectively, it's very hard to identify individual contributions to labor, and that means that people tend to get average wages. So the distribution of income over this period becomes much flatter as you move from individual production on farms to collective production in factories.

Third thing that happens – not so much here, but you'll see when we talk about the transition to services – is that you don't see, in the long run, a diminution of competition; because once people learn to trade differentiated, manufactured products, these are big global markets. Firms cannot effectively erect barriers to entry, although in the transition you tend to see national monopolies in things like automobiles and so on; but in the long run there is not a big transfer of wealth from workers to firms who aren't able to establish barriers to entry.

The current crisis is very different. It's not so much a cost of transition, that manufacturing is dying, and it's nobody's fault. Productivity growth is, again, five percent or so; and global demand growth is two percent. Nobody is going to change those numbers. Manufacturing is going to die, and what it means is – and that collapse, by the way, and everybody trying to preserve the jobs, has been exacerbated by this huge Asian manufacturing capacity that came online in China and India at roughly the same time.

As it collapses people try and export their way out of the problem. So you get all this export competition; even though the problem, by the way, is not exports. You can look at the numbers. When Ross Perot talked about the giant sucking sounds of jobs going to Mexico, of the loss in employment – that is, between the rise in U.S. consumption of manufacturers and employment in manufacturing – 15 percent of it is lost to imports; 85 percent of it is technology. Today those numbers are one third globalization, two thirds technology. This is a technological problem.

But again, you're not going to solve the problem through exports; because when you add up, over all countries on this planet, manufacturing exports and imports have to sum to zero. So far the policy solutions are nowhere in sight, and some of the things that we've seen in the interim – again, there's a common symptomatology, an extended downturn. You see the international imbalances over a long period of time. By the way, the international imbalances are associated with financial market dislocations.

When we run a deficit of $600 billion a year with China, they get $600 billion, whether they like it or not, that sooner or later is going to have to be invested in the United States. Foreign money is almost always stupid money. That $600 billion is fresh meat for people on Wall Street to create products for. They started out putting it safely in government instruments. Interest rates were driven down. They were not happy with that, so they looked for something else; and presto, Wall Street provided them with mortgages. Again, that is a natural reaction that you're probably not going to get to change short of the kind of liquidation that Stalin did.

Again, those imbalances are persistent. Japan has done it for self-protection. Germany has managed to do it, because they've managed to control their exchange rate through the euro with the rest of Europe, that they have powerful unions and powerful industrial firms. China has done it for macro simulation. You have countries like Korea, Indonesia, Thailand, and Malaysia that did run deficits; but as they ran deficits, they had to finance them with foreign borrowing. Because they continue to run deficits, because they were part of the balancing act on a global scale, people lost confidence in their ability to repay. Their currencies collapsed. Everybody went bankrupt because they couldn't pay their overseas debt.

But as their currencies collapsed, guess what happened to exports? They went way up. Imports went way down. They went from deficit to surplus, but somebody's still got to eat the surpluses. They're never again going into deficits, so you have these chronic surpluses out there that were exacerbated by natural resources. They generated financial surpluses, and there are no easy solutions.

On the other hand, there is something that is worse about this present crisis. In the depression the problem was a problem of transition. It was not a problem of destination. Industrial jobs and industrial activity is economically better activity than agricultural activity. Again it's because it's centralized, because it's joint activity, and that's why you see high levels of productivity growth and relatively flat levels of income.

Service jobs – and here I want you to have a model in your mind of what I'm talking about. In the United States today, there are 140,000 nonprofessional extractive works. That's all the coal miners, all the oil platform workers, all the copper miners, and so on. There are 260,000 professional athletes and referees. If you think of those two jobs, the mining productivity takes place in institutions that are large institutions with big technological and engineering input. Everybody tends to get paid roughly the same amount, because they work together. The jobs are also – there are no sociological adjustments associated with jobs.

When you look at these service jobs, they take place, like the professional athletes and referees, in decentralized institutions, so it's hard to generate productivity growth; and there is a large dispersion in abilities of people who are working individually. Years ago George Stigler did an analysis of this in single practitioners versus law firm lawyers, and that leads to a much wider distribution of income. So you have adverse productivity consequences. You have adverse distribution of income consequences, and also you have skill requirements that are very different from the old industrial skills; much more different than the transition from agriculture to manufacturing.

In particular – and I guess I'm going to say this, because I always want to say something that's going to get me in trouble – service jobs are jobs that involve human interactions. All the evidence is that women are better at that than men. Manufacturing jobs are muscle jobs, and it's just the opposite. So we also have, really, fairly fraught sociological changes associated with this transition to services.

Just to show you the data, this is what happened to productivity per man hour through 2011. The picture is not different. The first thing to notice is that, for the first time since the Second World War, the U.S. has the highest rate of productivity growth. That is because we are the most advanced service economy with the biggest service institutions. That's why, to some extent, the problem is worse in Europe – and actually Japan is doing moderately well – than it is in the United States. If you look at Italy, productivity growth is zero. Canada is surprisingly low. It survives through post downturn in sort of the same way; and strikingly, we actually do well in the 2009 recession.

So the normal order of international performance – which is, the Japanese did best among the G7 economies; the Europeans do the second best; and basically the Canadians do slightly better than the United States – has been completely reversed. But it is a global problem. These productivity growth numbers are substantially below what you saw in the wake of the transition to manufacturing. To show you this in detail, I want to talk about Japan; because it's a perfect example of not understanding what's going on.

The discourse on Japanese problems is a discourse of zombie banks and demographics. That is a demand side discourse. Nobody talks about productivity growth in Japan versus the rest of the world. You can decompose changes in Japanese growth compared to U.S. growth and changes in hours worked, which is where the demand side comes in, and changes in output per man hour [where 00:24:54] the productivity growth comes in. If you will notice, the difference in hours worked pre 1990, when Japan fell off a cliff, between Japan and the United States, is one and a half percent. They grow one and a half percent – employment hours – one and a half percent more slowly than the U.S.

Post 1990 it grows one and a half percent. That's the extreme, I guess, right-hand column as you look at it. They grow one and a half percent below the rate of growth in the United States. It is not a demand problem. Productivity growth in Japan pre 1990 was two and a half to three percent above the U.S. More recently it's about half a percent behind the U.S. This is entirely a problem of industrial performance, for reasons that we really should know and recognize; which is, they do not have the same kinds of service firms that we do; and they are devoting all their resources to what historically had been a wonderful productivity machine in manufacturing. It's as if they are trying to be a world economic power by concentrating on agriculture; which by now – trust me – is dead.

I guess I can tell this story. You never know when things are being streamed, but what the hell. I gave a speech like this in Japan. My reward was, I got to have dinner – not alone but with several other people – with Prime Minister Abe. They obviously get briefed on what you'd said. I said I understood why they wanted an export surplus, because they felt their imports were essential, and their exports were discretionary. I understand that that meant manufacturing, but that was a dead end in the long run for them. What he said, when it was my turn to get his blessed attention, is – he said, ah, Professor. I used the agricultural example. I said, listen, you're going to go the way of agriculture.

He said, ah, Professor Greenwald, you will be pleased to know we've finally learned to export agricultural products. I guess I was pleased to know that, but it had nothing to do with the problem that you see in the data. Until he comes to terms – they come to terms – with having to do services, it's going to be a big problem.

The second problem that is endemic has to do with savings rates. When the distribution of income becomes more unequal, savings rates should have gone up. If you'll notice, in the United States, they've actually had to go down to sustain full employment. So before the crisis the top 20 percent actually has about 50 percent of the income. They save about 20 percent of their income. That's a 10 percent national savings rate. If the savings rate gets down to six percent, it means that the bottom 80 percent of households are dis-saving four percent. They have 50 percent of the income. It means they're spending 108 percent of their income every year, and that is not sustainable.

That is what the numbers looked like before the crisis, and the crisis was coming. The distribution of income problem is a huge problem, as well as the international imbalances, for underlying economic stability. So the differences are also that services tend to be locally produced and consumed. When you have a local market, it is a small market. Small local markets, both in product space and in geography, are dominatable. You can have a single firm dominate them. Big global markets are almost impossible to dominate.

When you have economies of scale protected by some degree of customer captivity, without doing any rent seeking, if you concentrate on achieving those market positions, you will make a lot more money. That is another aspect of this transition that you can see. If you look at corporate profit share of national income, it's about eight and a half percent pre 1990. It's a little higher in the 1989-1981 business cycle. By 2014 it's basically averaging 14 percent of national income.

Investment is not going up. This has not returned to increased investment in business, and somebody talked about that. I think it was you, Mark. When you have monopolies, they tend to invest less; and you also see less investment because people don't contest those markets. That's exactly what you're seeing. So in addition to the slowed productivity growth and the misdistribution of wages, the adverse change in the distribution of wages, you're also seeing a shift from labor to capital; all of which exacerbates the problem. It's very hard to say it's anybody's fault. The only benefit is, you have these administered prices in local service markets. They tend to be more stable than competitive prices, so you get a shocking degree of price stability through the crisis. '

So the differences in terms of what happened in the depression and what got us out of it in World War II is, fundamentally the destination in this transition is not a happy destination. You're not going to fix it with corporate governance. This is a global problem. It is a national problem. You have to do something about productivity growth, and you have to do something about the distribution of income. I think I'm a better Marxist than anybody else in this room. You don't want governments futzing around with this one. You want to have a massive earned income tax credit, which is just by rule. You do, in the United States, want people to work.

If you have a guaranteed national income, people are going to be really pissed off, as they are in Europe, all these retirees; and you're going to have to think about having institutions like the Agricultural Extension Service that, in these decentralized service industries actually concentrate productivity growth. Short of that, this is going to be a long, difficult siege; and if you distract businesses from making this transition by insisting on government steps that cause a deterioration in management performance, you're going to make this worse. Thank you.

Edmund: Well, it's a great pleasure to be here, and it's always stimulating to hear Bruce Greenwald expound for us his latest ideas.

Bruce: They aren't just mine.

Edmund: You and Joe – so of course I'm happy to talk about, happy to be invited to talk about, Bruce's narrative of the downturn. I'm sure the organizers expect that I would also take some time to expound my own narrative. Bruce speaks of economic performance as having three elements: growth, distribution, and job satisfaction. I was first put off a little bit. It seems so pedantic, but I got to like it after a while. It's kind of a convenient way to organize things.

As for the causes of the decline, he has lots of interesting things to say. He speaks about collective work taking the place of individual work. He speaks about fewer jobs for strong-back labor, about monopolies sprouting up. As for corporate governance – which, I think, is the principle topic of this meeting – which is the main cause of the economic problems, in the minds of many people here, Bruce is skeptical that corporate governance has gotten any worse. I hope I've gotten that reasonably accurate.

I wouldn't say that the economy has driven off the rails by a long cycle, because I don't think that really – to use the word long cycle doesn't really explain anything. Where is the causation? Bruce refers to manufacturing, which is dying; but I'd like to see more about why it's dying. I may have missed elements in his oral presentation just now. He speaks of competition from abroad. I'm not sure what's new about that. I think certainly the United States has had – there were eras in which the United States had plenty of competition from abroad.

Yes, productivity growth; but I thought that's what we're here to explain: Why has productivity growth slowed down? That's where we should start. I wouldn't amuse the Keynesians by talking a great deal about the Keynesian views. In my book, "Mass Flourishing," I cited a large set of developments, economic and social, that – in my opinion at any rate – help to explain the great slowdown of the American economy. Yes, somewhere in there I pointed to CEOs whose retirement pay would suffer heavy losses if their corporate undertook a venture that failed. Maybe that's not considered a sound argument anymore. I thought it was kind of clever when I wrote it.

I'm not going to go through the 10 or 20 hypotheses that appear in chapter 10 of "Mass Flourishing." I think that would be tedious, but I do want to talk about some aspects of the causation. Most of the hypotheses of mine are instances of a general thesis that innovation is behind economic growth – in figure one. Furthermore, economic growth is a big force behind economic performance. By economic performance I mean job satisfaction, participation, et cetera. If you want to condense all this, you can say, well, modern values are the great driver of economic performance.

Bruce: You've got to go back one.

Edmund: I nervously hit the button twice, I guess. I always was pretty sure that such a cross section would come out pretty well for me, but I must say I was startled at how close that fit is. By the way, I could have done these charts in a somewhere different way; but I think what I've presented here is good enough. So if this nation of ours still had the right values screwed on, we would not be gathered here today. We would be having rapid growth, high job satisfaction, et cetera, et cetera.

Now this leads straight to a couple of themes of mine. First, there are likely to be ways to medicate some, if not all, of those suffering from the slowdown of the economy; or ways to repair some malfunctions in the economy that play no part in the slowdown. For example, the government could get serious about low wage employment subsidies in order to pull up participation rates and wage rates at the low end. The government might cut tax rates on corporate profits, on the belief that such cuts would induce increased business investment.

I favor low wage subsidies; but as an economist, I have to say that such employment subsidies are a one-off measure that might double wage rates at the bottom. But that's no match for the rapid growth that we used to have, which doubled wage rates every 24 years, time after time after time. These are just one-off palliatives. The Congress has enacted corporate tax cuts that may very well stimulate annual business for a while, business investment for a while. Look at the editorial in today's Wall Street Journal.

But such an effect cannot be permanent, owing to the law of diminishing returns. If you keep on investing, investing, investing, piling capital on the economy; but you don't have any innovation to provide improving techniques; you're going to run into diminishing returns. That must be practically on page one of elementary textbooks on diminishing returns. It's not just labor that runs into diminishing returns on a fixed plot of land. Capital runs into diminishing returns with a fixed set of people and technologies. So the Trump tax cut can only bring a one-off lift to the capital stock, as they argued at the [AA 00:41:50] meetings in Chicago two years ago. By the way, it looks like it's already beginning to happen.

More broadly I would argue that operating on the economy is not a solution. It's necessary to restore in the people the good values that once brought rapid economic growth and thus the good life and, perhaps, to extirpate the values that obstruct economic growth. If we do that, we can hope to see rapid growth again. Another theme of mine has to do with the social strife alongside the economic decline in the west; in particular in the U.S., the U.K., and France. I'm referring to the discontent expressed by the yellow vests – I won't try my French on you – in France, by the working class in rural America opposing immigration, and the northerners in Britain favoring exit from the EU.

What accounts for these feelings? Here it's necessary to remark on the severity of the losses of indigenous innovation in the U.S. Growth of real average labor compensation per worker slowed from two to three percent per annum in the 1960s to around one percent or less since 2005. Real interest rates, which are a pretty good proxy for the rate of return to investment, have fallen from two or three percent decades ago into what looks like negative territory now. Finally – very important, I think – data show that reported job satisfaction has declined appreciably since the data started in 1972.

I don't think it's recognized – not adequately recognized – that all this is absolutely extraordinary. One would have to go back, perhaps, to Britain in the '60s and '70s, or even the Weimar Republic from 1918 to 1933, for a comparable decline; in the west, at any rate. With this background, I think it is clear that the people who saw their wage rates stagnating feel pain and embarrassment that their wage rates have not gone up in parallel to the incomes of others; that the relative wage fell. The great economist Adam Smith would have said that, I'm sure; and I know the great philosopher John Rawls would have said that.

However, I want to make another point. I think that these people also feel frustrated; frustrated that their many years of hard work have not brought them appreciable wage gains, regardless of what's happening to other people. So it's a double whammy. Two things are going on that are very serious. Had western societies not been hit by the severe economic decline, the rural groups and others whose wages virtually stopped growing in this country for 40 or 50 years would have been gratified to see their wages strongly rising over those decades; whether or not the more advantages groups enjoyed still faster wage rates. In that event it seems unlikely that these members of the working class would have been so angry. Seeing that they are getting ahead, they would not have felt put to shame that others had done even better.

So we need to resume innovation, not only for the economic growth and even the job satisfaction it could be expected to generate, but also for the restoration of wage growth among others who would have otherwise no wage growth at all. Thank you.

Professor Mitts: Thank you both for that. We have about 10 minutes or so, maybe a little less, for questions or comments from the audience. Professor Gordon –

Jeff: Ned, so Bruce said that firm level governance solutions would not advance the cause, and focusing on them to distract us from structural issues. So do you agree with that or not agree with that?

Edmund: I think I agree with it, but Bruce's basket of structural factors are different from my basket.

Bruce: My basket has only got one egg in it.

Edmund: My basket is rich.

Professor Mitts: Easter is approaching.

Edmund: My basket is all about individualism from the Renaissance and all that stuff – Cervantes, Shakespeare. I wish you'd all read "Mass Flourishing," and then – some of you have, I know. There's a rich palette of values that came bubbling up in the west, but it's run into competition by a lot of antithetical values; very collectivist, solidaristic kinds of values that don't prize individualism, don't prize experimentation, discovery, exploration.

I know in the four or five years over which I was writing "Mass Flourishing," everything I saw resonated with what I was writing at that time. I don't think the situation has changed much.

Bruce: I think that's a no. All these other things have to change; not corporate governance.

Edmund: We both agree there have to be fundamental changes, yes.

Jeff: Let me just add a kind of editor's note. So thinking about this from a broad perspective, we're governance specialists, many of us here, anyway; and have thought about that. It's [their 00:50:34] streetlight. So I think part of the real challenge to moving the field forward is to figure out what governance can do, what it, can't do; where other places to look might be; how governance type questions are part of it; but each of these are quite different stories as to what, from one perspective, is the source of malaise.

Colin, do you have a thought here?

Colin: Well I think the difference in perspective – I was just saying that I think, Ned, your perspective, which places a lot of emphasis on values, is one of the issues that underlies this conference, as to whether or not the values of modern society are purely focused on those of financial returns. In that regard, what you've just been talking about is absolutely central to the debate that we've been having. I think, Bruce, from your point of view, it's got nothing to do with that.

Bruce: It's relevant. That's exactly right.

Colin: It's got to do with standard economic [unintelligible 00:52:07].

Bruce: I would say nonstandard economics –

Colin: Or nonstandard economics –

Bruce: – because the one thing I think people in this room – and I think you know this. Productivity growth, which is what underlies the improvements that Ned is talking about –

Edmund: No, they're the fruit, or a fruit.

Bruce: – okay, the fruit of what you're talking about – comes not from movements in the production possibility frontier. If you look at the microdata, the most efficient firm in an industry – and this is in aggregate terms or in terms of things like how efficiently they issue a bank credit card, cash card; and people have studied that. The most efficient firm in an industry with the same labor force essentially, the same level of capital, and seasoned technology, has a cost structure a third to a half of the industry average; which means that all those other firms – and you certainly see this in global comparisons of productivity levels, because technology is global – are way within that frontier.

If you look at the process of productivity growth at the micro level, it all comes from movements to that frontier; not in movements in the frontier. That is a managerial function. If you distract managements from that kind of innovation, I think you're going to have a huge loss in the beneficial things that Ned is talking about.

Edmund: Could I just interject: Although I think the need for the Renaissance values; need for a return of them, revival of them, strengthening of them; is fundamental, that doesn't mean that many, or all for all I know, of the reforms that Bruce would like to see are not necessary. Maybe some or all of them are quite necessary. I'm saying, though, that they're not sufficient.

Professor Mitts: We have a lengthy queue, so let me keep it moving.

Edmund: Merritt over there –

Professor Mitts: Yes. I just recognized her. Then I'll – yes, go ahead.

Female Voice: Thank you. So Mr. Phelps, you mentioned the need for innovation to help the American worker, especially the workers whose wages are currently stagnant. I think there's at least a [unintelligible 00:54:37] argument that currently innovation, particularly in the tech sector, is actually a driver of income inequality. So can you elaborate a little bit on how you see innovation helping those workers whose wages are currently stagnant?

Edmund: I'm not sure I got all of that question, but I think it's touching on the point that not all innovations are homogeneous and beneficial to all workers and things like that. Is that a fair recapitulation? I agree that the future is unknown. We can't, with any – expectations of calm seas all the way – we can't be entirely confident that innovations will make a difference for the better for most people. It's too bad, but it's the way the world is.

I do feel confident, though, that if we don't try to nourish more innovations on a wide scale, then we won't get out of the mire that we're in now.

Bruce: I think you're absolutely right. If you look at innovations today, what they're doing is, they're extending and empowering individuals, not organizations. It starts with the personal computer. Then you get the internet. What an individual can do now with those innovative things is extraordinary compared to what you could do when I had to go to the library to collect data. You can do in minutes what took days before.

What that's going to do is exacerbate the differences in ability between individuals. The successful societies, I think, are the ones where those individual differences get attenuated; they don't get exaggerated. Unfortunately - and I didn't talk about it – because this is a global problem not just a U.S. problem, and the services transition is really global; and countries that haven't done it have suffered much more in productivity growth, by the way, than the United States. But technology is going that direction, too. I don't know how you're going to stop that with corporate governance. So I think that's a really good question.

Professor Mitts: Merritt –

Merritt: Ned, I guess I was surprised that you thought corporate governance was not relevant to –

Edmund: I thought I qualified this. I think it may be, for all I know, necessary; but I don't think it's sufficient, because I think the most fundamental thing that's missing is the people. We've got a pretty impressive machine there in our economy. My God, it's so incredibly sophisticated; but the people are not making exciting, venturesome uses out of it.

Bruce: Can I try and say [unintelligible 00:58:23]?

Merritt: Go ahead.

Bruce: If you think about differences across corporations, they're much wider in behavior than difference across countries in average corporate behavior. My sense is that, what that tells you is that it is the corporate cultures and the national cultures that Ned is talking about that are far more important than the specific rules of governance. I'll say that in slightly different terms. Progress comes from specialization. The problem with boards of directors is that they're not specialized. The problem with a lot of these – activists, interveners, are not specialized.

When you see a highly specialized intervener, like Paul Hilal, the results are extraordinary; but that's not something that corporate governance worries about. One of the speakers mentioned it, which was expertise, which tends to be specialized. Unless you can meld these corporate governance regimes to enable them to take advantage of the power of specialization and the power of culture, you're not going to get the sort of thing that Ned is talking about.

Professor Mitts: Alan –

Alan: So I think the suggested reform that Bruce [made], which is the earned income tax credit, is something that our society know how to do; because we've had it, and we can expand it. I haven't read Ned's book, but changing value structures – I'm just wondering how implementable that would be. That is, is there something concrete we could do? In a way it's easy to follow the concrete thing that Bruce suggested, but how do I make concrete your high level analysis; even if I'm persuaded by it?

Edmund: Well, people who had contrary values were able to promulgate those values rather effectively. So why couldn't it be that, in the next round, the desire to get back to the earlier values – why wouldn't that be possible? I think it's almost a case where wanting it half of the battle. We can change the school system so that it celebrates adventure, creation, imagination, exploration, discovery, night and day, all the time. In a couple of decades I would think that that would be felt in society and in the economy.

[talkover]

Professor Mitts: – Ron –

Ron: I want to come back to Bruce's most recent comment; because at first I thought it was beginning to identify a course correction that governance could do, and then like Charlie Brown's football, it disappeared quickly. I want to make sure that that's right. So the fact that drove your point, which was enormously powerful, is basically, two thirds of the companies in a particular industry are badly managed.

Bruce: Yes –

Ron: Okay, great.

Bruce: – or they're not as well managed as they should be. Badly is a word that's value laden, depending on what you think of the average.

Ron: Right, but we're talking about the bottom two thirds. This one's easy.

Bruce: Yes, relative [unintelligible 01:02:41].

Ron: But now the next question – and this is what raises the governance question – is the extent to which there are mechanisms that may cause the other two thirds to do something that, in fact, they have the capacity, probably, to do, but aren't doing it. There may be – so your point, for example, about the capacity of a board structure; which, as we talked about this morning, is 40 years old and probably is past its sale date: The question becomes, can we design mechanism – almost by definition they've got to be external to the company's decision making, which has been failing at this point – which have some promise of adjusting their performance?

Bruce: I think that's a really important point. You've got to think about that. But what you've got to, I think, understand, and this is the history of activism: There are useful interventions, and there are dysfunctional interventions. To give you an example, the single greatest cost of a recession is not the temporary unemployment. An average recession in the United States leads to a permanent – or used to lead to a permanent – 1.2 percent drop in productivity. So productivity growth fell by 1.2 percent, and you never recovered. That's what the data tells you.

That's presumably because, during the recession, these managers are concentrating on fixing their balance sheets, and they're not concentrating on improving [in activities 01:04:27]. You can imagine opening channels for outsiders to intervene; but the question is: Are those outsiders going to be a distraction, or are they going to be the Paul Hilals of the world, who now change the lives of two railroads in ways that have been beneficial for everybody associated with them?

My sense, as a professor of investment management, of the investment community out there, is that they're ADD troublemakers. The Paul Hilals of the world you can count on one hand. Does that answer your question?

Ron: Well, almost; because all I want is one last twist. Companies have different kinds of problems, and different kinds of techniques are going to fit for fixing that. Speculating, if the activist's intervention is selling the company or straightforward structural changes, the numbers look like they work. The circumstances where an outsider is coming in who doesn't have deep knowledge about the company, and they're going to fix the soft managerial side – my guess: If we broke the data down that way, those would look like big losers.

So the question becomes, can we design an intervention system which allows somebody, credibly, to distinguish between the two; which I view as a task for governance that we're not doing now; but it's not obvious to me that it can't be done.

Bruce: See, I think it can be done under the present governance rules. I'll tell you honestly: I'm chairman of a hedge fund in Europe that's very, very concentrated. We do one kind of company in four countries, and we know exactly what we're going to do when we take it over. We have made an obscene amount of money. It just embarrasses you, the kind of salary you make; and I make an unseemly large salary for a university, compared to what you make doing that.

It's not hard to do. You can take over a company in Europe with basically 30 percent of the stock, the voting stock; and if you know that industry well enough to know which executives have historically done extremely well with these very special kind of companies; and they say, yes, they are going to stop the Chinese subsidiary stupidity; you can do it today. I just think that it's the supply of people like that – not me; it's the person that actually runs the hedge fund – and the Paul Hilals of the world, that are important; not the rules, because their value added is so large, this one third to one half of cost, that they can work within the present contract.

Ron: But for our purposes, the rules aren't what is getting in the way. It's the lack of imagination.

Bruce: Yes.

Professor Mitts: I hate to cut this off, but we are getting very close to cocktail hour, and Kristin is giving me the look that we should move things along. So thank you very much, to both of you. This was [really terrific 01:07:43].

Bruce: I can't believe you called me a traditional economist.

Kristin: Okay, so I'm just going to quickly make some closing remarks before –

Male Voice: I'm going to tell everybody –

Kristin: – anyone moves. Thank you all for being here. Thank you again to everyone who spoke and gave us their thoughts on these important issues. I want to say another thank you to the Richman center for their support for this program and also to the Millstein Center's assistant director, Brea Hinricks, who has done a ton of work on this program.

One other thing: In the next few days you're going to be getting an email from me asking you for the top three things that you found most interesting, challenging, that you want to see more research on, and why. So start thinking about those things now, and respond to me with those.

All of the materials from today will be on our website under our counternarrative project, and we'll eventually have recordings of the sessions up as well. Hopefully if you're feeling depression by Bruce's comments, you can drink away your sorrows in the hallway. We're just set up right outside the room around the corner. Thank you all for being here.

[End of recorded material at 01:08:54]