

Remarks by

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Presented at the annual business forecast luncheon of
the University of Chicago Graduate School of Business

Wednesday, December 6, 2006
Hyatt Regency Chicago

Economists are often disparaged and I'm sick of it. People say we are experts at predicting the past. And they say economists are people that didn't have the personality to become accountants. Let me say right now that predicting the past is not nearly as easy as it has been made out to be and accountants are surprisingly lively.

Today I am going to give you some business forecasts but not the usual GDP growth and inflation kind. That's not my thing. Instead, I am going to start with some inflammatory statements to get your attention and they will serve as a bridge to some of the compelling research coming from the faculty at the GSB whose insights you may find interesting.

I will give you five specific predictions relating to the international economy, the national economy, and two industries to watch. But wait, if you listen to all five, and act now, I will include a sixth bonus prediction absolutely free.

PREDICTION 1: THE NEXT 24 MONTHS WILL MARK THE START OF THE CHINESE BANKING CRISIS

It has been a big year for the banking industry in China. Next week, the WTO rules kick in and China will officially open its domestic banking industry up to foreign competition. This comes on the heels of China IPOing its big national banks like the Industrial and Commercial Bank of China—the ICBC—which recently had the biggest IPO in history.

But China's banking history is not good. For many years they had only four “banks” in the whole country and I use the word banks in quotations here because they weren't really banks the way we think of them. In these banks, lending has not been driven by analysis of business fundamentals the way it is in a normal bank. Ultimate authority in these banks came from *and continues to come from* a cadre of party apparatchiks. The government owns these banks and has always used them to keep moribund state owned enterprises alive.

I don't need to tell you that the loans they have made have been geared toward politics and not profit. I'm sure you wouldn't be surprised to learn that the ratio of non-performing loans at these banks before the government decided to IPO them got as high as 25%, or about 20 times more than comparable Western banks.

The Chinese government knew it had to clean up these balance sheets to attract foreign money. So they first took all the non-performing loans and shunted them off onto what they termed "asset management companies." That cleaned up one side of the ledger.

They then transferred \$45 billion of the country's reserves to these banks. That shined up the other side. With these glorious balance sheets, the IPOs looked great and foreign investors scrambled to get in.

The problem is, do you really think that the banks are now applying Western financial standards to their loans? My colleague Anil Kashyap at the GSB has been analyzing the Chinese banks in his research and has shown overwhelming evidence that these banks continue to make politically based loans just like they did before.

The government owned banks are loaning money to state owned enterprises near Tibet or in rural provinces where the government is trying to convince people to stay for political reasons, not economic ones. The government's primary goal seems to be preventing mass movements of homeless job seekers to the cities in time for the 2008 Olympics. That's not a good sign for the banks. McKinsey did a study of the loans of one bank to a particular province and found that in 60% of the cases, the bank didn't know the basic information of what collateral had been used, what industry the company was in, or who in the bank had even approved the loan.

This is an ominous sign for China. So long as the country grows at 10% a year, the banks can cover up their problems. At the first downturn, though, the whole thing will begin to crumble. The state owned enterprises will begin losing massive amounts of money and then the Chinese government will have to decide whether to require the banks to keep giving out cheap credit that they know will never be repaid or let the enterprises go under. Recall that Japan faced stagnation for 15 years because they were unwilling to bite a very similar bullet throughout the 1980s and 90s. I don't see the communist

Chinese government being more willing to do so than their democratic, capitalist neighbors. That is why I forecast the beginning of the Chinese banking crisis.

PREDICTION 2: MANUFACTURING'S SHARE OF THE ECONOMY WILL NOT STOP DECLINING IN 2007—BUT IT'S NOT ALL BAD NEWS

Manufacturing as a whole has taken it in the shorts for the last 6 years. The decimation has led the political leaders from both sides of the aisle to call for ways to rebuild our manufacturing base. We have special tax rates for manufacturing. People are trying everything to stop outsourcing, off-shoring, and all other manner of industrial decline. To be completely clear—all of these efforts will fail. If you come back in ten years and look at the manufacturing share of the economy and especially the manufacturing share of employment, it will be even lower than it is today. The sector has been in steady decline for something like 60 years, the last 6 have only been slightly more dramatic than the trend.

Much of the decline is inevitable. In technical terms when productivity growth is as high as it has been and demand for manufactured goods is not very elastic, that's what happens. As costs are cut in half, say, from the march of technology, the prices go down but people don't buy that much more of the manufactured goods. Employment in the

sector and the share of spending in the sector get smaller and smaller almost as proof of how productive it has become. It is exactly the same process that agriculture went through—US agriculture is immensely productive but a small share of the economy.

US consumers spend a significantly smaller share of their incomes on manufactured goods than they did in the past. Manufactured stuff is cheap nowadays. We spend larger shares on services—health, education, *lawyers*, everything. So it really isn't surprising that manufacturing employment would fall.

On top of that, most manufacturing uses medium and low skill workers and in a global market, that is not the U.S.'s comparative advantage. We are never going to have the lowest wages in the world. The way that we compete when our wages are ten times greater than China's is by being ten times more productive—it's really only select industries where that is true and they tend to change over time, requiring us to constantly innovate to stay ahead. Think of any time in the last 50 years and ask what the highest tech industries were and then how those industries seemed ten years later. They rapidly fade into lower skill manufacturing. Memory chips, computer hardware, hard disks, telephone equipment, VCRs, everything.

We have had a visitor from the London School of Economics named John Sutton at the GSB this year as part of the new Initiative on Global Financial Markets that I am co-directing. Sutton is one of the world's experts on industrial change and globalization.

One of Sutton's views about the United States' prospects is that we, unlike virtually any other developed country, have developed a core flexibility in our product development, our labor market institutions, and our higher education system that allow us to change what we are doing much more rapidly than in countries like France, Italy, Germany and Japan. His view is that flexibility will be the number one most important fact of globalization in the coming decade and by that measure the US looks pretty good. That's why I forecast that although manufacturing continues to decline as a share of the economy, the long run situation for the US looks good.

There is one measure that makes me nervous, though, which is the relative decline in our higher education. We all know the ways in which our high school educations lag the rest of the world's. But we have always had a greater share of young people going on to college than other countries. It has been the thing that makes us such a high technology center in the world. Well, the rest of the world has seen how much we have benefited from it and have tried to copy us as best they can. They have opened college educations up to the masses the way we do and have encouraged people to go. As a result, we went from being ranked first in the share of 24 year olds with a college degree to being 14th with 10 more countries within 3% of us. We are sandwiched in between Bulgaria and Costa Rica.

Indeed, often we are the ones educating their best and brightest. Foreign students make get almost half the science and engineering Ph.D.s and the \$15 billion we received in

tuition from foreign students made education one of the United States' largest exports—bigger than wheat, corn, steel and aluminum combined.

We must maintain a focus on academic excellence or else we will be on a path to middle income status. Unfortunately, in the near term my prediction is that US exports of education will continue to grow at astounding rates and will not be matched by a similar growth in domestic students. Hopefully we can start turning this around soon.

PREDICTION 3: THE OFFICIAL DEFICIT NUMBER WILL SHRINK IN 2007. THIS IS A SHAM. THE REAL DEFICIT IS EXPLODING.

The economy continues to grow at a fairly robust rate. The stock market has done well. So tax revenues have come in at slightly better than expected rates so the deficit will probably shrink—officially, that is. As most of you probably know or could sense, however, the official deficit figures are a joke. The one true dark spot on the US picture is our totally unsustainable fiscal position.

First, you should disregard the official numbers because of the accounting. Some time ago the government got tired of people seeing how much they were actually promising to spend so they switched to cash accounting. Nothing counts as a cost until it is actually spent. So the social security system is bringing in tons of money which it was supposed

to use for your retirement. But they don't have to actually start spending money on your retirement for a few years sooooo, they can count the cash coming in as revenue and not count the what they will owe as expenditure. They are almost literally charging money to a credit card and calling it income.

Now if you take the total value of what we are on the hook to pay and the amount that we will raise in taxes, do I really need to tell you that they don't add up? Boy do they not add up. The latest numbers indicate that the net present value over the next 75 years is almost \$70 trillion. According to some budget experts, by the standard of a business, the nation is bankrupt.

And the Medicare prescription drug bill made this a lot worse. It may have been complicated, poorly understood and fraught with bureaucracy but, as my father-in-law would say, at least it was expensive. This one act added something like \$20 trillion to the true fiscal gap in the country.

All of these things are taking place underneath the official deficit numbers and will not show up until later because of our government's Enron-like accounting system but you can see exactly why I forecast that even though the deficit looks like it is falling, the truth is actually, as the President might say, going nuclear.

What this means for business in the future depends a lot on how we bring things in to balance. To pay for the difference with taxes would take an increase of all income taxes by 85%. As economist Larry Kotlikoff says, that seems infeasible and potentially ruinous. Yet the spending cuts required would be equally draconian on social security and, especially, medicare.

Soon, perhaps not in the next 24 months, but soon, there will be a contingent of people starting to worry about the temptation of the government to inflate away the deficit—printing money to pay off debts. If the inflation crowd starts getting traction, long term interest rates will start rising dramatically.

So far the only good news about the deficit is that capital markets must believe that the US will eventually confront the problem with spending cuts and tax increases rather than printing money because despite these fiscal developments, long-term interest rates remain low by historical standards.

PREDICTION 4: PREPARE YOURSELF FOR A HEDGE FUND SHAKEOUT, SCANDAL AND, PERHAPS, REGULATION

It has been an incredible run for hedge funds the past several years. You couldn't get any hotter. Hedge funds control something like \$1.2 trillion of assets under management including money from pension funds, wealthy individuals' investment portfolios and even

a sizable chunk of our own university's endowment. The typical fee structure is 2% of the assets each year and 20% of the gains.

That's a nice living. I was at a dinner party with a guy who runs a very big mutual fund company and I asked him how he had been doing. He said that he had made a terrible investment mistake some years ago and he was still paying for it. I said, "wow, that must have been some crappy stock."

"It was no stock," he said, "it was not turning my mutual fund into a hedge fund!"

I heard that they did a survey of HBS students asking what they wanted to go into when they graduated and Hedge Funds was #1. So you *know* it's time to start shorting.

Now the problem is, amidst all the plenty, there is a group of hedge funds that has the potential to be the next major accounting scandal. See, most hedge funds take their 20% of the capital gain each year. It's not like most venture capital funds or private equity funds where they take the 20% gain at the end when the money comes out. For these hedge funds, the gains are calculated each year marking to market. If the hedge fund just invests in big stocks like Google, say, there's no problem. Computing the market value and the capital gain each year is easy. But now think about all the illiquid, private, strange things hedge funds invest in and ask yourself this: how do they calculate how much the market value has changed for these things each year? That's what they base

their annual 20% on. The problem is marking illiquid things to market is prone to shenanigans, as we learned just a few years ago.

With a downturn, it is going to become immediately obvious that some hedge funds have been grossly inflating the values of their holdings and raking in huge fees based on those values. No manager is going to want to stay at a fund where the gains are underwater for the foreseeable future so you are going to see mass departures and some fund collapses. And then you will see the investigations.

Eliot Spitzer won in a landslide so do you have any doubt that Attorneys General across this country will take up the cause of the wronged pension fund, the duped university, the innocent trust fund kid like Paris Hilton...okay fine, not Paris Hilton but face it, even without the AGs involvement, somebody is going to get their brains sued out. When they do, there is a decent chance that Washington is going to move to regulate hedge funds' behavior—mandating disclosure at the least and probably something much more involved. It could be a very nasty road ahead for the hedge funds.

PREDICTION 5: THE CUBS WILL NOT WIN THE WORLD SERIES

(BUT THEY WILL BE SOLD BY TRIBUNE, EVEN THOUGH NEWSPAPERS ARE BECOMING MORE LIKE SPORTS TEAMS EVERY DAY)

Going way out on a limb with this one. But actually this is just a ringer. I raise this prediction mainly to talk about the media industry. The Cubs' current owner—the Tribune company—is not long for this earth. In all likelihood, they will be broken into pieces and sold off within the year. One of those pieces will be the Cubs and it will likely go to a sports owner somewhere who is a closet Cubs fan and has dreamed his whole life of seeing the Cubs win. It will be a vanity purchase.

The problem facing Tribune and all other newspaper companies is that increasingly newspapers are becoming vanity purchases, too. Local groups including famous people like David Geffen are lining up in Los Angeles to buy the LA Times. Local hero Jack Welch is trying to buy the Boston Globe. These people are wanting to control the media they think of as representing their hometown. There is, perhaps, no better sign that newspapers as a business are in trouble.

What's interesting is that some of our own GSB professors have been researching the economics of media bias—about how partisan various newspapers are and what seems to make them so. And they have found that when operated as a business, who the owners are has almost nothing to do with it. The old bugaboo that Rupert Murdoch would one day buy every newspaper in the country and turn them all into the New York Post just doesn't hold. The single best predictor of the slant of the paper is...the slant of the audience. The New York Times Groups' newspapers in Tuscaloosa, Alabama slant the same way the other Alabama papers slant. They don't reflect the views of the New York

Times Group, they reflect the views that will sell newspapers. That's because doing anything else loses a great deal of money.

I think the local bigwigs trying to buy the newspapers think that they can change the focus of the papers to better interest local people. They are just wrong. Where local bigwigs buy the newspaper as a vanity project, they will start changing the content and within two years the papers will then start to lose even more money than they already have.

BONUS PREDICTION 6: FOR THE FIRST TIME SINCE DEAN SNYDER TOOK OVER THE SCHOOL, OUR BUSINESS WEEK RANKING WILL NOT IMPROVE

In case you hadn't been following, it's pretty tough to improve on #1. Now, we have never really put excessive weight into the rankings so we aren't going to start now. But, still, it was our first time being number 1 and the students were thrilled. To the extent that it brings attention to the GSB and our distinctive culture and intensity, all the better. If you are a GSB graduate and have not been back to see the new campus, you should come. But watch yourself. I have seen people that look just like you wandering around the building and announcing to no one—"when I was here, the desks were so small that anyone over 5'10" had to crouch," and "the food was so bad when I was here that I gained 10 pounds when I joined the marines."

Yes, you will confirm the oldest prediction of all. One year, 10 years or 100 years from now, old people will still be saying that the world is going to hell in a hand basket. And the best and brightest coming out of places like Chicago will still be proving them wrong.

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