

## Bruce Greenwald on Structural Problems in the Economy and Unemployment

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*We spoke with Greenwald on November 4. This installment of the interview covers his macroeconomic forecast, and next week’s will detail how he has positioned First Eagle’s portfolio.*

**I’d like to understand your economic forecast, and specifically I’d like to focus on the question of unemployment. At what point you believe it will stabilize? I see a lot of attempts to forecast unemployment using a technical approach based on**

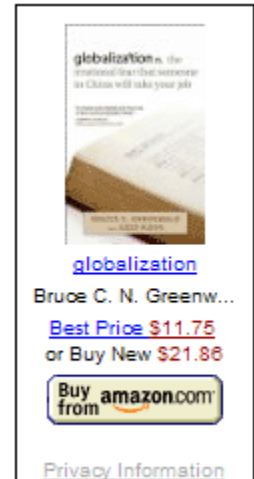
**past statistical patterns, undertaken without regard to the structural problems in the economy. What are the structural issues that will govern when unemployment will reach equilibrium?**

To answer that, you must first understand why this situation has been so bad and so prolonged – and I think it’s going to be much more prolonged. The first evidence that you have to think about is that while this is the first occurrence of problems this severe in the US, these problems have been around in Asia, Argentina, Mexico, Russia – and Japan, of course, most obviously – for many years. This is not new.

You want to go back and think about what is going on. In a sense, you are seeing issues that are going to take a long time to fix and are similar to what happened in the Depression. Basically, in the Depression a huge sector of the economy that everyone had always regarded as central, died. And it dies for an almost virtuous reason.

That sector of course is agriculture.

Since about 1870, productivity growth had been 4% to 5% and demand growth had been 1% to 2%. Agricultural prices had been up before and during the first World War, and then they were down. But the inexorable trend had been down, with all this growth





in productivity and limitations on demand, and sooner or later prices were going to collapse. Approximately 35% of the US population was either in farming or in farm towns or were supporting a farming enterprise, and they were going to be marooned.

So when you look at the countries that suffered the worst as a result of the Depression, they are the big agricultural producers: the US, Australia, Canada, Germany, France, and most of Europe, but not the UK or other countries that were less agriculturally dependent. Japan was very agriculturally dependent, and they suffered terribly and quickly in the early 1930s, but fortunately for them they started a war in China and entered the second World War right away. The country that never recovers is Argentina.

When the Depression happens, the challenge becomes how to get that portion of the population that is trapped – because their housing, jobs, and capital are in agriculture – to the manufacturing enterprises. The answer is that is very hard to do.

### **The conventional wisdom is that World War II ended the Depression. Is that correct?**

The reason why World War II got us out of the Depression, and the reason that Argentina suffered because it didn't participate, is that it is actually industrial policy that gets everybody off the farms.

That policy also accumulates purchasing power, so that when people are in the cities, there is demand for appliances and cars. They have moved and they are now part of the productive economy. So the demand is sustainable.

One of the great concerns at the end of WWII was that everyone thought we were going to go back to the Great Depression. In Argentina, of course, that happened. In the US and everywhere else, everyone was surprised and relieved. But the reason is that you've gotten everyone off the farms and into the cities. It was through both the war industries and in the army.

### **How does this relate to today's problems?**

The comparable thing that is going on today is that manufacturing is dying, and it is dying for exactly the same reason, which is productivity growth is 5% to 6% a year and demand growth is 2% to 3% a year.

That's why Japan has had such a difficult long-term problem. They are manufacturing-driven, and they think of themselves as a resource-poor country, where their imports of food, energy, and raw materials are absolutely essential. They want a huge margin of safety of exports over imports. The only way you can do that is by manufacturing. That's harder and harder to do as manufacturers die. So they've basically done a little



bit of what was done in the Depression, which is that you've got to employ these people. And many countries, like Japan, try to do it through exports.

China has decided to grow, and they can't grow based on domestic demand, so they have to do it through international demand, and that's of course demand from manufacturing. They have exactly the same problem as Japan. They have a command economy, and they have sort of kept their workers busy, but they are heading for big trouble. Manufacturing employment hasn't grown for three years in China, and that's a huge problem for them, despite the fact that, like Japan, they are manipulating their currency, which is just a modern version of protectionism. And they're generating exports.

Japan and China are in the same situation. Germany is too; they have powerful unions and powerful firms, and basically those who they are undermining – because they have fixed the Euro exchange rate – are the other European countries. Overall, the Euro should go to \$2.50. But there is no way they will let that happen, because they would go from surplus to deficit, and all their manufacturing jobs would be gone.

Then you've got Korea, Thailand, Indonesia, and Malaysia, all of whom used to run deficits. The problem was that they had to borrow in foreign currencies to finance those deficits. Everyone got nervous about the deficits. Their currencies collapsed. The burden of debt destroyed the manufacturing countries predominantly. But they went from deficit to surplus because their imports collapsed and their exports took off. They're never going to run deficits again, and you see it in the data. They've been there and don't like it and they're not going to do it. Brazil, which had the same experience, is pretty much in the same place.

So you've got these enormous trade surpluses as a result of countries trying to sustain in various ways their manufacturing bases, partly because they have people marooned there. But also, like with agriculture, they think they can't have a successful economy if nobody makes anything.

You go into a Japanese factory, by the way, and nobody makes anything. There are more people on the loading dock, which is a service function, than there are actually in the factory. That's why they are a hopeless enterprise.

### **Which countries are in a position to play a leadership role in solving the crisis?**

There is one iron rule that must hold, which is that the sum of all the surpluses and the deficits across all countries has to be zero.

Somebody has to eat the surpluses. It used to be Malaysia, Korea, Indonesia, and Thailand, and they paid the price and went from deficit to surplus, but somebody still has to eat their surpluses. So ultimately it goes to the country who can accommodate



that, because it can borrow in its own currency. When the dollar falls, we don't suffer the way the Koreans did, with unserviceable debt. The US is the deficit country of last resort.

The Asian countries are running protectionism – just differently – by manipulating their own currencies. They don't do tariffs, and that's why the dollar hasn't been able to fall.

The problem from the perspective of the US is that if we are importing 9% more of our GDP than we are exporting, it is very difficult to sustain full employment. You basically have to have a zero saving rate or a bubble in the internet or housing. But you have to have some substitute demand.

### **Is there a sustainable source for that demand?**

There is a phenomenon that helps this take place, and it's really what generated the financial crisis. If the US buys \$900 billion more than we sell overseas, the surplus countries accumulate that \$900 billion. That number is growing every year. They have to get rid of that money, and the only way they can get rid of that is to go from surplus to deficit, and that would destroy their economic growth.

The US controls how surplus countries deploy dollars in the US. They are not going to be able to buy US equities – we showed them that in Chevron – and they are going to have to buy US fixed income. That drove down long Treasury rates, and Alan Greenspan had nothing to do with it. They got tired of the low yields, and they looked for other fixed income. They are poor, uninformed investors, and we sold them a lot of bad mortgage-backed investments. Interest rates got to be really low in the US, and there was a housing and consumer lending bubble, and savings rates went to zero. And that's what sustained growth in the US, which sustained demand, which sustained all the manufacturing industries.

There's a weird stability to this, because the Chinese can't do anything about it. If they try to get rid of their dollars, they can buy Euros. But then the Europeans have the choice of letting the Euro go to \$3.00 or buying the dollars themselves. And then they go back and buy the Yuan, and then the Chinese have the choice of letting the Yuan go up and undermining their exports.

The problem comes with consumer demand in the US. Basically the saving rate went to zero. In the US, the top 20% of people have 40% of the income and save about 15% of their income. A lot of that is pension plans and paying off principal on mortgages, so it's automatic savings. If you take 15% of 40% you have a savings rate of 6%. This means that the bottom 80% is earning about 60% of the income and is spending 110% of their income. That is not sustainable. So, finally when housing prices collapse and the defaults in consumer finance occur, that whole system falls apart.



## **So we are left with unsustainable consumer demand in the US and an imbalance in global trade. What is the solution?**

You'll notice that we basically fixed the banks, but the underlying imbalances are in no way fixed. Those who suffered the worst, in international terms, are the Japanese and the other big manufacturers. So what you've got is this fundamental economic imbalance that hasn't gone away, which is going to mean slow growth.

We can resolve this by just directing tariffs. But Obama plays nice with others, and he's not going to do that, which would harm the rest of the world. We can't try to control our currency, because if we sell dollars we would drive the price of the dollar down, and Japan and China would just buy them and sell Yen or Yuan, and there's no percentage gain in doing that.

So the actual way we could relieve the pressure is to have the IMF just print money and give it to Korea and the other countries so that they could buy Chinese and the other exporting countries' goods without having to incur foreign debt. That is the Stiglitz plan and that's the plan that the Chinese are talking about.

At the same time, you'd like to tax the surplus countries to force them to adjust. That's a short-term solution. The long-term solution is you have to get people out of manufacturing – and governments have to cooperate in this effort – and get them into industries like health care. Cutting health care is not a good idea at this point. They have to work in education, housing, and financial services. But if all those industries are under attack globally, you are not going to get the jobs that you need to replace the manufacturing jobs.

There is this huge structural problem taking place. The governments can offset it to some extent. I think what you are going to see in the US is what you saw in Japan for years, which is stagnant demand. We will grow a little bit, imports will flood in, purchasing power will go out of the US economy, and we will stop growing, and then the government will do something and the dollar will fall a little. All these things will happen sequentially, but ultimately you are going to have slow growth.

## **What does this mean for unemployment?**

The next phenomenon that people are not aware of explicitly but ought to be is that productivity growth doesn't come from innovation. It comes from people taking tried-and-true methods and actually applying them better. The reason I say "tried-and-true methods" is because, if you look at the most productive firms in an industry, they typically have costs that are a half to a third of the industry average. It's the same technology that everyone else has available to them. There's a huge opportunity for productivity and cost cutting.



Imagine that you've got basically 1% or 0% GDP growth and productivity growth of 2% to 3% per year. Employment is going to be decreasing by 2% to 3% per year. That means unemployment is going from 10%, where it is now, to 12% to 14%. I don't think there's a natural stopping place for that much below 15%.

That's the potential unemployment picture you are looking at. You are already seeing the political strains that is causing, which are that companies are going to make a lot of money, because they will drastically cut costs and their revenues are going to be constant. The stock market is going to go up. It happens every reporting season; they all exceed expectations. The unemployment situation is going to be a disaster.

We've seen this in Europe, and basically what it means is that people under 30 can't get jobs unless they are from the absolute elite universities. That's the sort of forecast you have to think about, and it's very hard to do that based on short-term movements in consumption. The savings rate has got to go to somewhere above 4%, and it's not there yet. It was up to 3.8%, and then went down to approximately 2.9% because of "cash for clunkers" and people buying furniture for their houses.

### **Other than Stiglitz plan, is there any other solution?**

This is the problem for the Republicans, even though they are going to win because it's going to be such a disaster for Obama. The Democrats are not going to improve things unless they get lucky. The services people have to buy are lots of health care, custodial services for old people, college education and graduate education, and housing. They are big lumpy expenditures, and the government has to help finance them. So, in the meantime, while you are making this transition out of manufacturing and you are getting these institutions and the private methods of payment in place, the government is going to have to borrow a lot of money and do a lot of support. That's going to be the hardest, because nobody has faced up to that.

We are actually in pretty good shape, because we don't have much of a manufacturing employment base left. To give you an example, we have more professional athletes and referees, including tennis pros and golf pros, than we have extractive workers, which include coal miners and oil platform workers. We have approximately 200,000 professional athletes and 180,000 extractive workers. It's just unbelievable what's happened to productivity in these areas.

You have a long-term solution, which is to do the transition, which the War did for us to end the Depression of the 1930s, which it never did in Argentina. Then you need a short-term way to relieve the pressure and generate the demand, and that's basically the Stiglitz plan, which is described in the last chapter of my book.



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