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Of Schumpeter, Erudition, and Regression to the Mean

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The great Joseph Schumpeter once observed that "[P]essimistic visions about almost anything always strike the public as more erudite than optimistic ones." As pessimistic visions abound in this environment, investors are awash in erudition to an exceptional degree. And no wonder. As I write these words, the news is bad, from stock prices to oil prices to home prices. The Fed confesses to being in a muddle, and the rest of Washington is even worse off (but less willing to admit it).

Any suggestion of a happier vision is hard to drum up and would, in any case, sound less erudite than the predictions from the prophets of doom. Nevertheless, these forecasters should take note of the bias in their current thinking. Kipling, in another age, reminded us that "If you can keep your head when all about you / Are losing theirs and blaming it on you....Yours is the Earth and everything that's in it / And—which is more—you'll be a Man, my son!"

In less erudite fashion, I recall a key principle of finance: regression to the mean. Remember J. P. Morgan? Yes, markets will fluctuate. On this occasion, prices are the driving force of regression to the mean—especially the prices of oil, food, and homes.

I would not venture to guess how long it will take for the dust to settle from the storms now afflicting the global economies, but I remain confident regression to the mean will prevail. Nothing goes in the same direction forever. If oil remains this high or goes higher, the pressure to economize and to find substitutes will inevitably curtail the growth in demand. High prices will also provoke greater supply, as the pressure for drilling in coastal waters of the U.S. makes clear. In the case of food, substitutes are less likely, but an increase in supply is a lot easier to achieve than in it is for oil. Even the Chinese will tend to slow the migration from country to city if the price of food is high enough. The opposite trends will prevail in housing, as production falls and lower prices tempt buyers.

Another popular concept of the moment requires more careful analysis than it has received. Many observers admit to a concern about "stagflation" in light of the outlook for low economic growth and intensifying inflationary pressures. These warnings are less wise (erudite?) than they sound, because people use the word stagflation with little thought as to what they are talking about. The so-called stagflation of the 1970s was not stagnation in economic growth. Real GDP grew at an annual rate of 3.3% from 1969 to 1979, which was hardly stagnation. Growth over 1988-1998 and over 1998-2008 was only 2.7% per annum for each decade. The trouble in the 1970s was in unemployment, which averaged 6.2% as the baby boomers poured into the labor market. The civilian labor force grew by 24.6 million people from 1969 to 1979, compared with growth of only 19.7 million during the preceding twenty years.

Today's demography holds nothing of that nature in store. The problem, rather, is not at the gateway to the labor force but at the exit, as those same baby boomers will soon begin departing the labor force to join the ranks of senior citizens.

As Schumpeter himself insisted, the capitalist system is a dynamic system that never stands still. Equilibrium, including Keynes's underemployment equilibrium, may have had theoretical interest but it has no meaning in the real world. The prophets who extrapolate today's despair into the indefinite future would do well to spend a few hours rereading Schumpeter.