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BROWN UNIVERSITY

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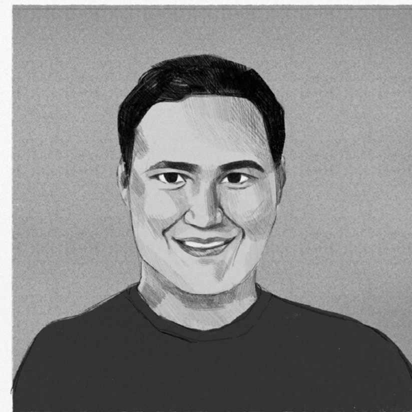
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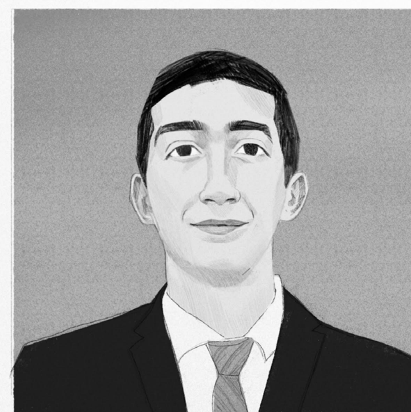
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Index Investing

The Story Behind Better Returns

EVAN POLINSKY / UNIVERSITY OF CHICAGO

Trading becomes a negative-sum game; the more trades, the smaller the pie.

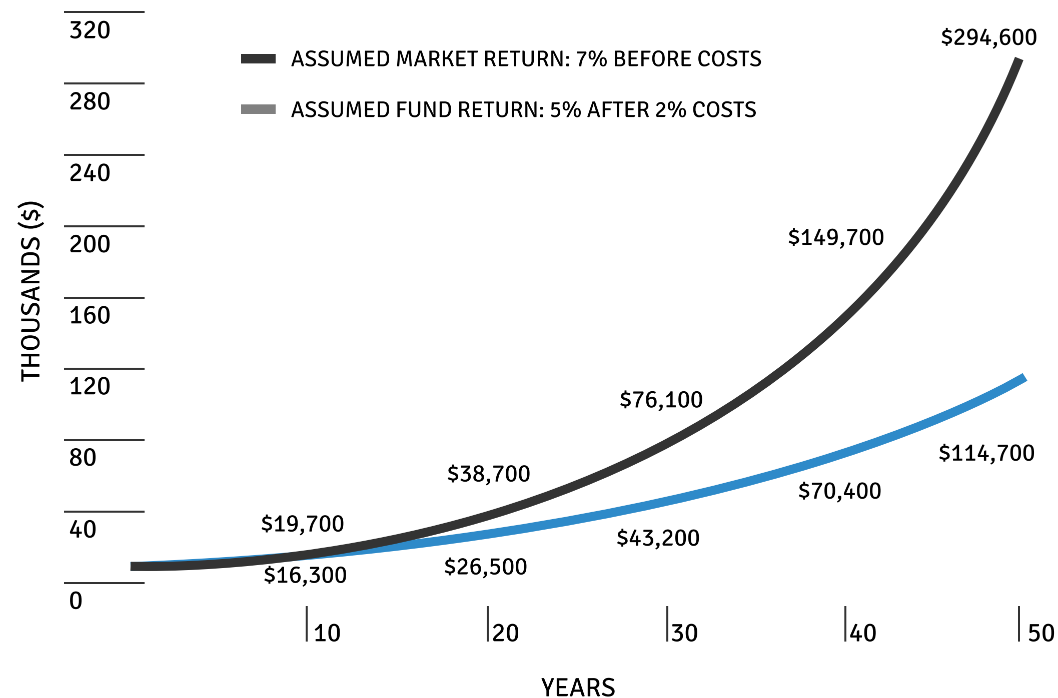
Meet the Gotrocks

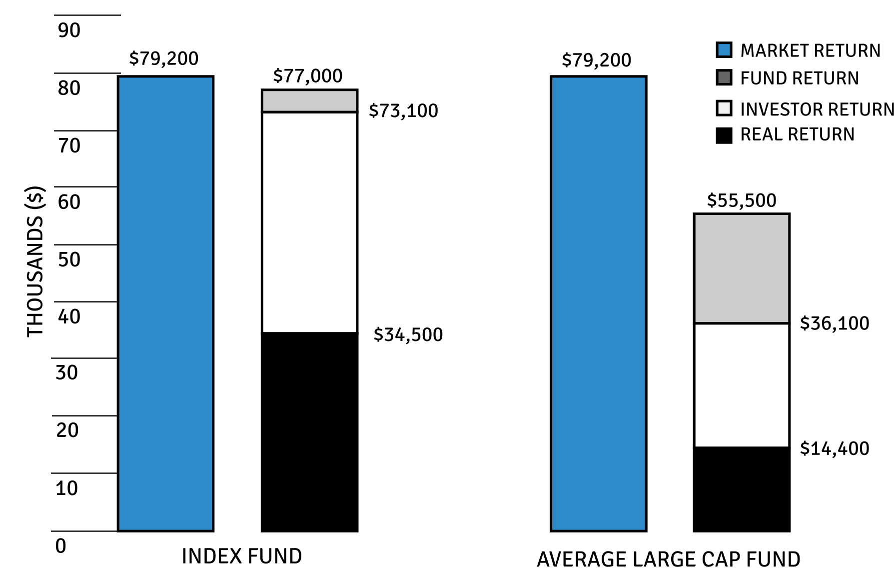
Let's start off with a story Warren Buffet shared in his 2005 shareholder letter: Imagine that the Gotrocks family altogether owns 100% of stock of every American corporation, which they split evenly among themselves. They have a combined wealth of $30 trillion, which grows about 10% every year. Last year, they collectively made about $3 trillion, which they all split evenly. Simply put, the Gotrocks are crazy rich, and they effectively grow their wealth every year.

One day, a Helper arrives on the scene and explains to some of the more ambitious and greedy Gotrocks that they should sell some of their shares to their cousins and buy more profitable shares in return. The Helper is nice enough to broker the transactions for a small commision. The trend catches on as each Gotrock wants to make the best portfolio he can by trading relentlessly.

Most of the Gotrocks aren't as successful as hoped. They realize that they should leave the trading up to an expert, so they hire money managers to do their trading for them for just a small fee. When their money managers aren't performing as well as they had hoped, they hire expert financial planners and investment consultants, who for a small fee will hire money managers for them.

A year later, the Gotrocks have their worst financial returns of all time. Rather than receiving 100% of returns, their returns are now divided up among Helpers (brokers), money managers, and investment consultants. The Gotrocks also find themselves susceptible to a capital gains tax for all of the trading taking place. Overall, their share of the pie decreased from 100% to 80%. The family realizes the mistake they have made and decides to get rid of all the brokers and managers and go back to just holding their money and reaping the reward themselves.





Index Funds are the Answer

What can we learn from this story? For one, if we look at investors as one big family of Americans, the whole investing practice seems a lot more sinister. Whenever you buy or sell a stock, you participate in a zero-sum game because there is someone else on the other end selling it or buying it from you. Introduce charges for these trades, and all of a sudden every trade you make with someone else leads to a small slice being taken from the pie. Trading becomes a negative-sum game; the more trades, the smaller the pie.

Then, add on to this what you are paying people to make trades for you, and the pie keeps on getting smaller. Brokers and money managers are like leeches to the economy who take away about 20% of gains for US households. You might not care about the measly 2% costs, but over the years, those 2% costs will add up to thousands of dollars.

This story also introduces the idea of owning the entire stock market as a whole. Since nobody is as wealthy as the Gotrocks, this might seem like nothing but a pipe dream. However, index funds change the game by allowing you to buy a proportionally distributed portion of every stock on the market, just like any other Gotrock. Index funds operate with minimal expenses, no advisory fees, negligible stock turnover, and high tax efficiency. Some might think that while money managers and brokers shrink the pie for everyone else, they still allow you to gain an edge and beat supposedly boring index funds. However, beating the market is a lot harder than it sounds. As nobel prize winner Paul Samuelson put it: "Investors should forsake the search for such tiny needles in huge haystacks, when they could just use an index fund to buy a haystack."

And those needles sure are tiny. A study found that over the past 15 years, about 95% of finance professionals could not beat the market. If you invested $10,000 in 1991, in 2016 you would have gotten a $73,100 return from an index funds, compared to $36,100 from the average large cap fund after the fund took its cut.

> "Investors should forsake the search for such tiny needles in huge haystacks, when they could just use an index fund to buy a haystack."

In fact, the market is also catching on, as funds that track U.S. equity index funds hit $4.27 trillion in assets as of August 31, surpassing stock picking rivals for the first time ever in a monthly reporting period, according to Morningstar.

Start Spreading the News... To Your University!

Students might not have enough money in the bank to worry about investing, but our colleges certainly do. As you might expect, almost all university endowments lose by choosing complex funds over simple index funds. Warren Buffett has criticized endowments and other wealthy investors for becoming reliant on complex investment products, which make them feel like " they deserve something 'extra' in investment advice" even though index funds available to anyone are "clearly the best choice."

For instance, Harvard spends millions of dollars paying its "Helpers" to make an exotic portfolio that consistently loses to the market. A group of Harvard alumni took Buffett's advice to heart, writing to their University that they would like half of its $37.1 billion to be shifted to an S&P 500 index fund. I suggest that we urge all our universities to do the same.

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Global Trumpism and the Future of Globalization

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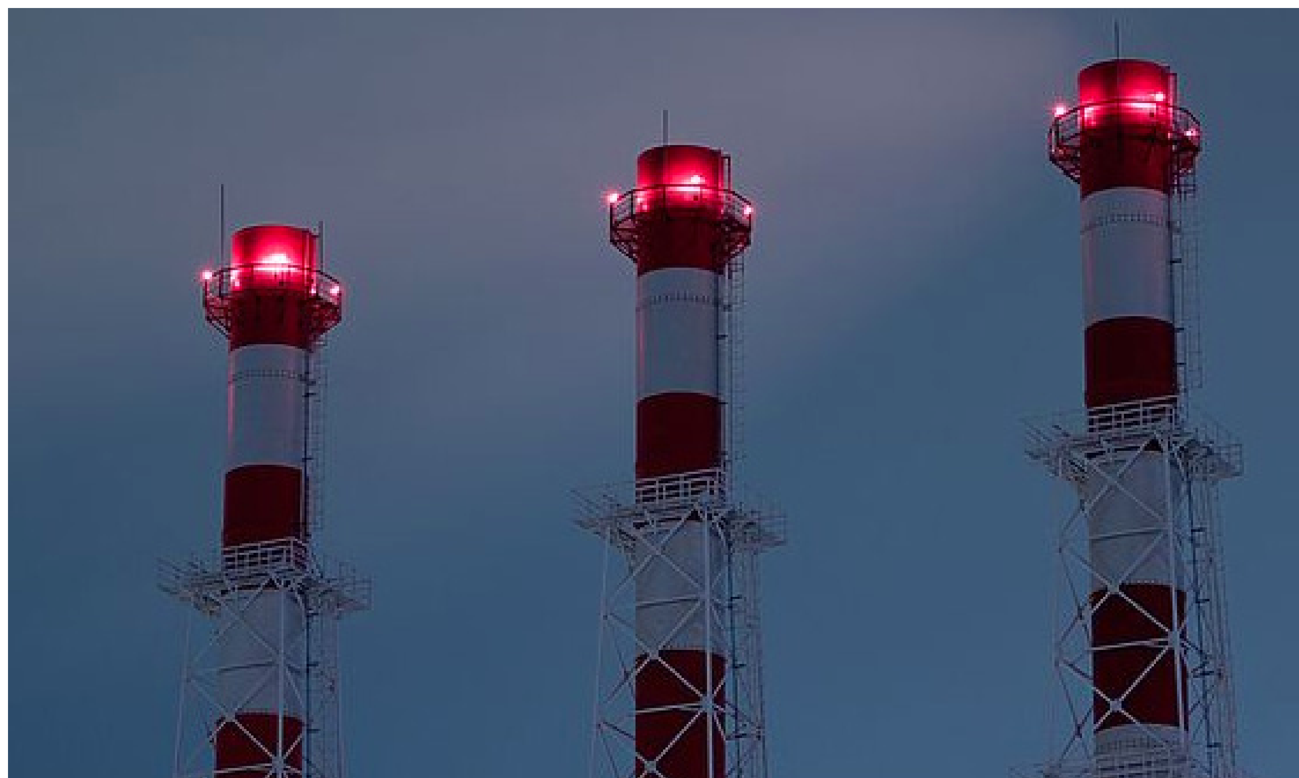

Globalization, despite its rising preeminence in the U.S.' lexicon, is nothing new. The term, referring to the flow of trade and investments across national borders, gained popularity in the 1990s, though it could easily apply to the 17th-century activities of the Dutch East India Company or the Silk Road trade that began in the 2nd century BCE. Globalization has always been spurred by technological advances: in the 19th century, for example, it was the invention of steamships and telegraph lines that served to connect countries across the globe. Today, globalization is driven largely by the internet.

Though globalization has become a charged term in today's political discourse, the interconnectedness of the world's economies has substantial benefits for both businesses and consumers. The most obvious example is the availability of goods—due to open trade, Americans enjoy Nintendo gaming consoles, and residents of Tokyo munch on burritos and Big Macs. Furthermore, globalization increases the quality of goods alongside their availability. Quality improvements are caused by two factors. First is the downstream availability of intermediate goods: raw cashmere is harvested in China, spun into yarn in Japan, and fashioned into sweaters in Pennsylvania, a state without natural access to the luxurious fabric. The second factor in quality improvement is specialization, which allows countries with comparatively low factor costs (such as labor or natural resources) to produce goods more cheaply than countries with comparatively high factor costs. Specialization allows producer countries to focus on goods in which they have a comparative advantage; this leads to superior output, which, through trade, can be enjoyed across the world.

With all of its benefits, the steady march of globalization seems all but inevitable. Still, throughout history, waves of globalization have always been met with the natural opposing force: populism. Populism attempts to appeal to "ordinary people" who feel left behind by the activities of societal "elites." The latest upswell of populism is characterized by what Mark Blyth, professor of Political Economy at Brown University, terms "Global Trumpism," which is intensely focused on weakening or destroying globalization. In a radio interview with OpenAthens, Blyth explains that, "for the past 25 years the center-left has told the bottom 60 percent of the income distribution in their countries the following story: 'Globalization is good for you We're going to sign these trade agreements, and, don't worry, there will be compensation.'" This was accompanied by a move to the political middle—to where most votes reside. This move was perceived as an abandonment of the lowest quartile of the income distribution, which embraced right-wing populists like the eponymous Donald Trump, in what Blyth describes as a revolt against "elites" who most benefit from free trade.

The implications of populist policy on free trade are vast—if the assault on free trade continues, economies across the globe will suffer. Tariffs harm domestic consumers, who either forgo elastic goods or curb spending on other products if the purchase is inelastic. This in turn harms domestic producers, who not only lose domestic revenue but also find themselves the target of retaliatory tariffs (when the United States imposed tariffs on Chinese steel in 2018, for example, China quickly responded with its own set of levies on 128 US products). Furthermore, there is no telling the impact

that tariffs imposed today will have in a few years—or even decades. In 1964, in response to European restrictions on the import of American chickens, US President Lyndon Johnson imposed a 25 percent tariff on the import of light trucks. The repercussions of this act can be felt even today. According to Robert Lawrence, professor of international trade and investment at Harvard University, by shielding the US automotive industry from competition, the tariff disincentivized innovation and crippled that sector of the US economy in the long-term.

The impacts of blanket tariffs are wide-ranging and unpredictable—but so long as populism controls political discourse, tariffs will continue to harm firms and consumers alike. It is key, therefore, to address the economic insecurity that underlies the populist impulse to restrict free trade. There are several ways to do this. First, proponents of globalization must compromise and allow for some sensible trade restrictions. While unrestricted trade would lower prices for consumers, the costs to domestic industry would be devastating—and those costs are already being exacted. According to the Economic Policy Institute, the U.S. lost 3.2 million manufacturing jobs between 2001 and 2013. Most of those jobs migrated to China, which entered the World Trade Organization in 2001. Furthermore, the EPI estimates that this sort of offshoring depressed wages by as much as six percent for full-time workers without a college

degree, who accept lower pay in impossible-to-outsource jobs like landscaping and waitressing. Job loss on this scale created massive social disruption, as well; many scholars have identified decimated industry across the Midwest as the cause of the opioid crisis ravaging the Heartland. Absent protections, displaced workers will lash out against free trade; Hillary Clinton's "Blue Wall" crumbled when disaffected Rust Belt voters grew enticed with Donald Trump's populist appeal. Targeted tariffs, while not completely alleviating the pain of offshoring, would help to protect the most vulnerable jobs, creating a bulwark against economic and societal disruption and, by extension, anti-free trade sentiment.

Indeed, targeted tariffs have successfully guarded domestic industry in the past. In the early 1980s, American motorcycle manufacturer Harley Davidson was under siege from Japanese imports like Kawasaki and Honda. The company teetered on the verge of bankruptcy until President Ronald Reagan introduced a tariff that would start at a whopping 49.4 percent and gradually drop to the normal rate of 4.4 percent at the end of a five-year period, giving Harley Davidson the breathing room to overhaul its business practices to be more competitive with the Japanese. The tariff was so successful that Harley Davidson, in a show of strength, asked for the tariff to be lifted at the conclusion of year four.

Overall, there must be a balance between lowering consumer costs and protecting industry. While the U.S. government has historically used unemployment as the benchmark for economic health, unemployment is an increasingly inadequate metric for an age in which the labor force is in decline and wages are stagnant. The government must now take a more holistic view, considering factors like labor force participation, consumer spending, and underemployment when examining the effects of trade on domestic industry. When the balance is off, targeted tariffs can be corrective, minimizing economic and social disruption.

However, targeted tariffs are not sufficient aegis in a rapidly-changing global economy. The U.S. government should invest in worker re-training programs, which have proven effectiveness. It is important to note that re-training is a far more involved process than the oft-cited suggestion to convert obsolete workers into software engineers; the U.S. must produce higher-skilled workers who are less vulnerable to the destructive powers of globalization.

One way to do this is to shift the low-skill domestic manufacturing sector into a high-skill assembly sector (for example, the assembling of green technology). Another way is to reform the education system, emphasizing technical college (plumbers and electricians are impossible to outsource), lowering the cost of a four-year degree (with such measures as withdrawing federal funds from schools with high tuition costs), and introducing forward-looking curriculum like coding as early as elementary school.

Finally, local economies must diversify across industries, detangling workers from companies which are themselves reliant on exports and subject to the natural pruning that comes with globalization. The New York Times, in a 2018 article titled "What Happens to a Factory Town When the Factory Shuts Down?" details the aftermath of the closure of a GM manufacturing plant in Lordstown, Ohio—a decision motivated by cheaper manufacturing possibilities in Mexico. The plant had been a pillar of Lordstown for 50 years; when it shut down, 8000 jobs and $8 billion in economic activity were lost. Kesha Scales, a metal assemblywoman at the Lordstown plant, summarized her feelings: "I was so loyal to GM," she said, "but it's just a game to them."

Capital injections are key to diversification. Economists point to Detroit as an example of the ramifications of failure to attract capital. Michael LaFaive, Senior Director of the Mackinac Center for Public Policy, states that "capital, be it financial or human, goes where it's welcome, and leaves if it's not. And Detroit politicians for decades have repeatedly made capital unwelcome." LaFaive cites high taxes, poor services, and high regulation as factors contributing to Detroit's inability to draw in capital. The Detroit Economic Growth Corporation hopes to remedy this issue through the creation of "Opportunity Zones", which are designed to draw investment in certain areas of the city in exchange for tax relief on capital gains. This investment would drive jobs growth in the short-term—creating work in construction and maintenance—and in the long-term—improving the city's ability to flow goods and services.

Diversification can also be driven at the federal level. One solution recently embraced by the Trump administration is to move federal agencies from Washington, DC (one of the United States' most expensive areas) into the comparatively inexpensive Midwest. Midwestern states have already built out vast infrastructure, which once supported a booming industrial economy. Following industrial decline, much of this infrastructure is languishing. Matthew Yglesias of Vox contends that the federal government ought to "take the lead" in spreading coastal prosperity to the Heartland: "relocated agencies' employees would enjoy cheaper houses, shorter commutes, and a higher standard of living, while Midwestern communities would see their population and tax base stabilized and gain new opportunities for complementary industries to grow."

Globalization has created greater access to goods and services across the globe, improving the quality of life for hundreds of millions of people. But it has displaced workers and rocked economies across the world. If the global regime is to continue, domestic workers need to be swayed from a seductive populist sensibility with changes that require substantive economic reform on both local and national levels. Without action, all of the benefits that globalization has brought forth might end—for good.

Trade War Sparks Fears of Possible Recession

EMILY BELT

On January 22nd, 2018, President Donald Trump imposed tariffs on washing machines and solar panels. The first 1.2 million washing machines would be taxed 20 percent, and every subsequent washing machine would be taxed 50 percent in the next two years. Solar panels would be taxed 30 percent, with the rate decreasing over the following four years (Gonzales).

This law was the first of Trump's trade war, a series of tariffs on imported goods (including on musical instruments, frozen meat, aluminum, shoes, and more) from other countries, especially China. Now, a year and a half after the initial tariff, Trump has imposed more rounds of tariffs resulting in $360 billion of Chinese goods being taxed ("A brief guide on the trade war between the world's two largest economies"). By the end of 2019, this number is expected to increase to $550 billion Chinese goods taxed by the United States (Layne). In retaliation, China has imposed tariffs on more than $110 billion United States products ("A brief guide on the trade war between the world's two largest economies").

Trump initiated the trade war due to the United States trade deficit with China, which he claimed was a threat to domestic workers. Many middle Americans support the trade war with China because these Americans feel as though the reasons for their struggle with employment is that many blue-collar factory jobs have been outsourced to China, due to the cheaper production costs in China. These Americans believe that if production returned to the United States, they will once again have jobs. However, studies and statistics surrounding the trade war challenge the idea that the trade war will increase domestic jobs; in fact experts predict that the trade war could lead to a recession.

"This trade war, intentioned by Trump to help United States workers by making imported goods more expensive, has actually harmed domestic workers and consumers."

This trade war, intentioned by Trump to help United States workers by making imported goods more expensive, has actually harmed domestic workers and consumers. When tariffs are imposed, domestic companies who sell goods produced in China or sell goods produced domestically that require parts or

> "However, studies and statistics surrounding the trade war challenge the idea that the trade war will increase domestic jobs; in fact experts predict that the trade war could lead to a recession."

material imported from China have to artificially increase the price of these goods above what is equilibrium. When prices rise, demand decreases: domestic consumers either have to pay more for the same good (which may mean buying less of another good) or choose not to buy the good. Since the rise in price is due to the tariff and the extra money for each good sold goes towards paying the tax, when demand decreases, affected companies are earning less. If earnings decrease enough, some companies may have to lay off workers. In addition to earning less, uncertainty surrounding future trade policies can cause companies to hold back on certain long term investments and long term spending plans. As thus, this trade war has also delayed future growth opportunities for some companies (Layne).

These tariffs are not just affecting a few isolated companies. In fact, a study from the New York Federal Reserve reported that 79 percent of manufacturers experienced input costs rise at least slightly due to recent tariffs (Reinicke). Additionally, the trade war has caused noticeable financial loss. For instance, in July of 2019 alone, the tariffs cost domestic companies an estimated $6.8 billion (Layne). Similarly, a study conducted by Moody's Analytics estimated that the trade war has caused 300,000 fewer domestic jobs to be created and had caused the Gross Domestic Product to decrease by 0.3 percent, as of 2019 (Layne). The largest effect has been the loss of efficiency. A study conducted by the New York Federal Reserve in March of 2019 estimated that the trade war caused $1.5 billion of losses in efficiency. These statistics are not just hurting companies. In fact, the trade war has cost an estimated $3 billion in taxes, and, according to the New York Federal Reserve, "the full incidence of the tariff has fallen on domestic consumers so far" (Pinchen).

The stock market has also experienced losses. In August of 2019, as uncertainty around trade relations with China grew and as Trump increased tariffs, the Dow Jones Industrial fell by more than 600 points; since tariffs greatly affect the earnings of companies, investors feared losses would result in unprofitable investments (Stewart). Thus, both investors and publicly traded companies are hurt further by the trade war. As illustrated, the domestic economy is showing signs of reduction—rather than growth—due to the trade war.

Some experts predict that Trump's trade war with China will lead to a recession. This claim is fitting for a trade war since a recession, in basic terms, is when the economy shrinks instead of grows. The data and evidence presented point to a shrinking economy. In fact, this recession may be coming soon. In August of 2018, the yield curve inverted. Typically, investors demand higher interest rates on long term bonds than short term bonds because lending money out for longer is riskier. Lending money out for longer is riskier because investors are less able to predict economic conditions in ten years and thus are less able to predict whether the investment will default on payments. Additionally, investors have to wait longer to receive their principal investment back. Recently, however, the yield curve inverted: interest rates on two-year Treasury bonds became temporarily higher than interest rates on ten-year Treasury bonds. The yield curve inversion basically suggests that economic conditions are riskier over the next two years than the next ten years, which implies poor economic conditions over the next two years, such as a possible recession. Many experts, including from the Federal Reserve of San Francisco, state that inversions of the yield curve are generally followed by economic recessions, or at the very least economic slowdowns (Marte). Thus, the temporary inversion of the yield curve in August 2019 was the first sign that a possible recession is nearing.

Before Trump's Trade War causes a recession, action needs to be taken to quell possible poor economic conditions. In August and September of 2019, the Fed cut interest rates twice in a seven-week period. The cut in interest rates was meant to help encourage and foster economic growth and spending (Horsley). Some companies have avoided major losses by moving production from China to other countries, such as Vietnam (Sozzi). The most effective decisions in preventing a recession, however, would be ones that tackled the root of the issue: the trade war. If the United States can reach a peaceful agreement with China and can start decreasing its tariffs on Chinese imported goods, the United States can be saved from a recession.

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Can America Talk Itself Into a Recession?

TALIA SHAKHNOVSKY / BROWN UNIVERSITY

An Economy In Crisis?

"Global Growth to Weaken,"[1] "Fed Lowers Rates Again to Stave Off Recession,"[2] "The Yield Curve is Inverted."[3] Recent news headlines stress recession indicators. While the U.S. Economy continues to show stable 2% growth and unemployment continues to hover around its lowest level since 1969, the media and economists are shifting their focus to recession risk. As the old adage goes, economists have correctly predicted nine of the past five recessions. Some of their concerns: U.S.–China trade war tension, a decrease in long–term interest rates, economic slow down abroad, and low central bank interest rates limiting flexibility. However, this negative focus itself may be a self–fulfilling prophecy because emphasis of recession risk decreases consumer confidence, contributing to an economic slowdown. Consumer confidence, or consumer sentiment, measures how consumers perceive current and expected economic conditions. The Conference Board and Michigan Survey indices are the most frequent measures of confidence and show the same trends. Both surveys average data about current and expected general business conditions, job availability, and total family income. While standard economic theory states fluctuations in consumption depends purely on macroeconomic factors, growing amounts of research suggest consumer psychology itself can affect consumption. Consumer sentiment does rises as income rises, unemployment falls, inflation falls, and real interest falls. Knowledge of these macroeconomic conditions, however, explains only 70% of the variation in sentiment. According to regression analysis conducted by the Federal Reserve Bank of Boston on quarterly data from 1954 to 1990, consumer sentiment alone explains a statistically significant and sizable fraction of total consumption growth. According to the European Central Bank, there is a high correlation between consumer confidence and consumption (0.29). Moreover, the correlation between lagged consumer confidence and consumption remains high (0.25 over one quarter, 0.24 over two quarters), stressing that consumer sentiment is a precursor to consumption. Moreover, the data stresses that confidence indicators are especially good predictors of periods of shock or economic fluctuations, including recessions. These periods have more volatile consumer confidence, indicating that large changes in consumer confidence can predict trends in consumption.

1 https://www.worldbank.org/en/news/press-release/2019/06/04/global-growth-to-weaken-to-26-in-2019-substantial-risks-seen

2 https://www.usatoday.com/story/money/2019/09/18/interest-rates-fed-cuts-rate-quarter-point-again-prevent-slump/2354651001/

3 https://markets.businessinsider.com/news/stocks/yield-curve-inversion-explained-what-it-is-what-it-means-2019-8-1028482016

4 https://www.nytimes.com/2019/08/17/upshot/how-the-recession-of-2020-could-happen.html

5 https://www.nytimes.com/2019/08/30/business/economy/recession-trump.html

> "While standard economic theory states that fluctuations in consumption depend purely on macroeconomic factors, a growing body of research suggests that consumer psychology may affect it as well."

Historical Influence of Consumer Confidence

The 1990-91 recession highlights how a drop in consumer confidence can shock the economy. When the Iraqi invasion of Kuwait raised oil prices, consumer confidence fell, decreasing discretionary purchases. The New York Times states that this recession "can be attributed to a case of nerves," explaining that sentiment was not just an important factor, but actually the cause of decreased output. Consumer confidence rebounded in the first half of 1991, and by the second half of 1991, real GDP was growing again at almost 1% . So, consumer confidence was also key in forecasting the renewal of growth.

Confidence plays a much greater role in periods with large changes involving political tensions or financial crises. These "extreme" confidence changes are important because they correspond to the beginning of economic turbulence. For instance, the largest consecutive number of periods where confidence dropped was from 2007–09, through out the financial crisis. Joseph Stiglitz, a Nobel Prize winner in Economics, states that the 2007–09 financial crisis was a result of a catastrophic collapse in confidence. This decrease in confidence ensured the length and strength of the recession. Furthermore, in recent years, the American economic expansion has continued on the strength of consumer confidence. When growth slowed in 2016 because a slump in oil prices decreased business investment, America kept shopping, propelling growth. Consumers drive about 70% of U.S. economic activity.

Current Consumer Confidence

Although, consumer sentiment makes up over of U.S. economic activity, right now, it is decreasing. Consumer sentiment dropped 8.7% from July to August, the largest monthly decline since December 2012—consumer sentiment now sits at its lowest level in almost three years. September's sentiment reading represents the largest difference between economic expectations for consumer confidence and actual data since 2010. Other similar measures of confidence showcase the same results: only 44.8% of people responded that jobs were "plentiful" as opposed to 50.3% the month before[1] and Google searches for "recession" increased by over 500%.

Many consumers attribute this decrease in confidence to tariff concerns. One in three spontaneously mentioned the trade war when surveyed.However, others ascribe this decrease in consumer confidence to today's social focus on recession risk. Mr. Phillipson, acting chairman of President Trump's Council of Economic Advisers states, "The way the media reports the weather won't impact whether the sun shines tomorrow, but the way the media reports on our economy weighs on consumer sentiment, which feeds into consumer purchases and investments." As a result, dramatic recent news and constant discussion of the possibility of a recession may itself cause a recession by decreasing consumer confidence.

6 https://www.bostonfed.org/-/media/Documents/neer/neer193b.pdf

7 https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1349.pdf?159f2fc17e225f8b0f-062014b5a868da

8 https://www.newsweek.com/recession-fears-economic-downturn-consumer-spending-1457052

9 https://www.reuters.com/article/us-usa-economy-confidence/u-s-consumer-confidence-plunges-in-september-idUSKBN1W91XJ

10 https://www.marketwatch.com/story/us-consumer-confidence-sinks-to-3-month-low-on-trade-worries-softer-jobs-market-2019-09-24

Strategize and Compromise:

An Alternative to the U.S.–China Trade War

TIEN NGYUEN / BROWN UNIVERSITY

The Trade War

The U.S. Census Bureau reported that the U.S. trade deficit reached a massive $891.3 billion in 2018, $419 billion of which can be attributed to China. To lower its trade deficit, protect its intellectual property, and spur employment in the U.S, the Trump administration initiated a trade war with China, which has only prolonged a global economic slowdown. Backed by Section 301 of the Trade Act of 1974, Trump has continuously threatened China to accept the new trading negotiations. However, instead of escalating the trade war futher by increasing tariffs on a variety of China imports, the U.S should use a containment strategy as part of its pusuit to negotiate a deal that is agreeable to both parties. Doing so two would ultimately produce a win–win solution and preserve the relationship between the U.S. and China.

Theory vs. Reality

Even before his presidency, Trump despised China's trading practices and blamed them for the U.S.' rising trade deficit. Hence, it's no surprise, especially considering evidence of China's theft of U.S intellectual property, that the Trump administration would threaten and punish China through tariffs and taxes. Economic theory predicts that the tariffs, which increases the price of foreign imports, should increase domestic purchases of products from domestic suppliers. Furthermore, the tariffs should push U.S firms in China to relocate back to the U.S. Both effects, in total, should spur job creation and decrease the U.S.' rising trade deficit.

However, theory does not always accurately predict reality. The U.S.' 10–25% tariffs on $250 billion worth of Chinese imported goods have reduced consumer spending, created uncertainty for firms who have to make long term investment decisions, and damaged the U.S.' ability to leverageits relationship with China. JP Morgan analysts estimated that the direct and indirect effects of tariffs have cost American families an average of $1000, which has proved especially harmful to low and middle-income families. Because China's economy is 25% larger than the U.S.' but invests the same amount in R&D, the trade war only serves to hurt the U.S. in the long run, as it will restrict access to Chinese technology and resources. Furthermore, the tariffs have not pushed U.S. firms in China back to the States; rather, they have relocated to other developing countries, such as Vietnam and India. In addition, U.S. firms will not fully relocate out of China, because they depend on Chinese manufacturing as part of their supply chains. Altogether, the Trump administration's use of tariffs has harmed consumers and damaged the U.S.' trade relationship with China.

The Containment Strategy

Attempts to negotiate with China over a new trade agreement is difficult given that China has the ability to devalue its currency, the yuan, to maintain economic stability.

Alternatively, the U.S. should implement the containment strategy in order to make such negotiations easier. John Mearshimer, an international relations professor from the University of Chicago, proposed that the U.S. focus on cooperating with China's trading partners, such as Hong Kong, Japan, South Korea, and Vietnam, in order to isolate Chinese markets. The containment strategy would prevent China from forcing other countries to give it access to technology and research, as well as prevent the inflow of trade with major trading partners. This would slow growth in China's markets. Meanwhile, the U.S. would increase its trade inflows with China's trading partners, which would slowly decrease its trade deficit. Overall, applying the containment strategy would apply pressure to China and foster growth in U.S. markets, in addition to making potential trade agreements more realistic in the future.

A Trade Deal?

Nonetheless, negotiations should continue to be pursued and a trade deal is still possible. One specific proposal would be for China to agree to purchase a specified quantity of American agricultural products. This would serve to reduce the trade deficit considerably. In return, China would still have access to U.S. intellectual property and other innovations, which would bolster Chinese investment and R&D, and thus further strengthen its economy. Tariffs would be avoided to prevent the U.S.' relationship with China from deteriorating further; this would assuage firms' risk -aversion and make it conducive for them to make long-term investment decisions, especially considering that U.S. firms could still rely on Chinese imports. Compromise should be pursued over the tariff war in order to create a win–win solution for both parties.

> "However, theory doesn't always accurately predict reality."

Applying tariffs on Chinese goods has disrupted the global economy, reduced consumer spending, and hurt firms. However, using the containment strategy as an alternative to the tariff war to exert pressure will eventually lead to positive negotiations where a mutually agreeable compromise can be reached. This solution would preserve the U.S.' relationship with China, lower the trade deficit, and restore stability to the global economy. Such a win–win outcome would benefit consumers and producers from all ends of the spectrum and promote overall growth that is beneficial to all.

DRC Informal Economy

PAUL CUMBERLAND

The World Bank estimates that in 2018, the GDP of the Democratic Republic of the Congo (DRC) was 47.23 billion USD. The true figure, however, is likely twice that. This massive discrepancy is due to the DRC's 'informal' economy. The inability to accurately measure the DRC's economic productivity is both cause and symptom of longstanding inequities. Overcoming this obstacle is critical to ensuring inclusive, sustainable economic growth not only for the DRC, but for all countries with significant informal economies.

Beyond the Law

The informal economy may be considered to be all economic activities, enterprises, jobs, and workers not regulated or protected by the state. Think local craft production or subsistence agriculture. Informal economic actors aren't illegal in the typical sense—while the informal economy may include criminal enterprises, it doesn't have to. In fact, the vast majority of informal enterprises and companies are extralegal, in that they function outside of state knowledge and officialdom. This distinction is not mere semantics—it bears consequences for how such activity is perceived and regulated.

Consider, for example, roadside stalls outside Kinshasa, capital of the DRC. Each stall-owner operates as a small-scale distributor of agricultural or manufacturing products—i.e. a small business. And yet, it is unlikely that many stall-owners pay corporate taxes, which for "micro-sized companies" amounts to an aggregated 3% of goods turnover, plus a lump sum of 50,000 CDF (~$30). This doesn't mean that such stall-owners are pathological tax evaders. Indeed, they might be commended for being entrepreneurial under adverse conditions. Not paying taxes, in a setting devoid of efficient bureaucracy and a functioning judiciary, is arguably more a consequence of poor state capacity than criminal intentions.

Heart of Darkness

DRC's informal economy is significant. A recent IMF report in 2015 estimated informal employment at 24.5 million, approximately 88% of the formal sector. More consequential is that the informal economy represents 55% of total GDP. That is, more than half of the DRC economic output exists outside state regulation and measurement.

Though unregulated, this economic underside is diversified. Though there is little available data, informal actors assumedly include re-sellers (entrepreneurs who purchase goods and sell them on, for a profit), small-scale farmers, and local miners. This last industry, also called artisanal mining, is significant given the DRC's vast mineral deposits—it is one of the world's largest producers of gold, copper, cobalt, diamonds, uranium, and tantalum (a core component of modern electronics). While the majority of the DRC's mineral output is generated through industrial mining operations, certain deposits may be accessed with primitive technology, such as pan sluices. Though panning for gold deposits in the Congo River basin may provide wealth for the miners themselves, this wealth may also be harnessed to fund rebel militias. Congolese insurgent groups have financed conflict in part by acting as middlemen in the lucrative mineral trade.

Diamonds in the Rough

Insurgent groups, while not inherent to the informal sector, pose substantial risks to informal actors and the state itself. The opaqueness involved makes it difficult to deprive insurgents of revenue and prevent domestic money laundering efforts.
It also starves the state of resources it might use to effect and improve the policies designed to monitor these same informal

activities. The DRC has long struggled to improve its state capacity in various policy fields—education, health, defense, to name a few. Formalizing this sector could provide precious revenue to the state.

By extension, an improved GDP brings secondary benefits. Proper accounting of state assets and revenue stream potentially allow the state to obtain more favorable lines of credit and loans from development organizations. The DRC's bond rating currently stands at Caa1, indicating substantial risks. Greater available funds might enable a stronger position in loan and debt negotiations, setting better terms for the country's future.

The Road Ahead

Formalizing this portion of the economy, however, poses challenges. First and perhaps foremost, informal actors remain informal for valid reasons. The DRC state does not have a good track record of remaining impartial, just, or effective. Many informal economic actors are taxed directly by corrupt officials that demand payment for, say, setting up a stall. On top of this, a recent study indicates that the majority of the "formal" taxes aren't fed into the state hierarchy and revenue flow, instead being kept locally. In other words, market administrators and civil servants do not pass on collected taxes, but instead pocket them. As such, while regulation might theoretically make these businesses safer and provide them with better financing, it could increase state extortion or line the pockets of tax collectors.

Nonetheless, some reforms hold promise:

FOR ONE, the informal economy should be de-stigmatized. Most informal actors are not black-market criminals—they are simply trying to survive.

SECOND, the state should move to lower the barriers to entry for opening new businesses. Multiple permits, punitive fees, and complex regulation all discourage prospective entrepreneurs.

THIRD, expanding microfinance programs and relaxing collateral requirements to include alternative assets (such as inventories and moveable property) would provide crucial financing opportunities.

This list, of course, is not exhaustive. Significant challenges to formalization remain, most importantly state capacity and trust in the government. These issues cannot be resolved overnight. Addressing these issues head-on, however, is critical to insuring a more prosperous and inclusive Congo, for generations to come.

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Influencer Marketing

The New Face of Advertising

GENNIE FABER / UNIVERSITY OF CHICAGO

“80% of Generation Z and 74% of millenials are influenced by social media when making purchases.”

The Power of Influence

Last April, celebrities from every corner and tier of stardom flocked to Indio, California for one of the biggest social media events of the year: Coachella. Fans eagerly checked Instagram to see the crazy fashion on display. In the mix of posts was a slew of sponsored content – promoting everything from clothing to drinks to food delivery services.

This is known as influencer marketing. Influencer marketing uses stars on social media to promote products through their follower base. This practice is especially effective in targeting younger consumers. According to a study by Yes Lifestyle Marketing, 80% of Generation Z and 74% of millenials are influenced by social media when making purchases.

What is an Influencer?

Influencer marketing differs from traditional television endorsements because the use of social media allows an influencer to market products directly to their followers, people who are prone to take an interest in the influencer’s lifestyle. Any industry has its own set of influential people, and more and more companies are beginning to see the value in using their followers as the perfect target audience.

The crazy thing is, influencers can be anyone. Some of these influencers have gained fame through their acting, athletic, or modeling careers, but others have cultivated a following solely through their social media activity, whether that entail posting fitness routines, makeup tutorials, or lifestyle vlogs. In fact, an overwhelming number of influencers are real people like you and me, making their messages appear more authentic and relatable. The very meaning of “celebrity” is evolving as social media platforms legitimize all kinds of fame.

A New Way to Engange

Influencer marketing can take many forms. The simplest campaigns take the form of sponsored Instagram posts or Youtube videos. An influencer might post a picture in an outfit from a fashion brand they are working with or might upload a skincare routine that includes a product they are supposed to promote.

There is also a push for more experiential forms of influencer marketing. For example, Sephora Collection works with a troop of nine Youtubers. In addition to asking for the occasional sponsored post, Sephora Collection takes the girls on weekend retreats, where they learn how to use Sephora’s makeup and skincare products and spend time doing fun, photogenic activities that can turn into pictures for Instagram or videos for Youtube. Revolve, a clothing brand, invited 140 influencers to Coachella. These influencers were invited to an exclusive pre-festival with lots of great backdrops for Instagram photos and given outfits from Revolve to wear. Fans could shop their favorite influencer’s outfits on one webpage.

The Numbers Say It All

Brands spend a lot of money and effort to keep their influencers happy, but it pays off. Return on investment can be difficult to calculate, but a report from Marketing Week shows that in 2017, beauty influencers generated an average ROI of 881%. Compare this to the 153% Budweiser earned from its Super Bowl spots the same year, aired to millions of viewers who often tune in with excitement to watch the commercials. 86% of marketers have used influencer marketing, and of these 94% found it effective.

Why is this so effective? Likely, it is due to the strong connection between influencers and their followers. Nielsen recently published a study saying that 84% of consumers take recommendations from people they trust, while only 42% rely on online banner ads.

By sharing their lives through social media, influencers can build relationships with their followers, engaging with them in the comments sections or even through Instagram DM’s. The Geico gecko and the Budweiser Clydesdales may be cute, but they don’t feel like our friends in the same way that influencers do.

The Fintech Revolution

A Call to Reinvent Regulations in Banking

ANVITA RAMACHANDRAN / UNIVERSITY OF CHICAGO

> “Fintech companies are broadening access to financial lending services and paving the way for a more equitable industry.”

In April 2018, Revolut joined a fast-growing club of fintech “unicorns” boasting a valuation of over $1 billion. The London-based company provides an enticing value proposition in an industry plagued by rigidity and outdated systems. Its app offers a range of banking services targeted at young tech-savvy users, democratizing the money transfer process through exchanges in 24 currencies.

Yet, like many accelerating tech start-ups, Revolut has recently been under scrutiny. CEO Nikolay Storansky hopes to build the “Uber of financial services,” reflecting a questionable attitude that is eerily similar to that of Silicon Valley entrepreneurs and unlikely to work in the highly regulated world of post-2009 finance.

Revolutionizing the Banking System

Fintech companies like Revolut have been entering spaces where traditional brick and mortar banks have been stagnating, such as currency exchange and cross-border payments. Modern big banks still provide costly and cumbersome transfer methods. Payments are often routed through many institutions before they reach their destination, resulting in delays and fees. American high-street banks may charge over 5% for transfers in major currencies. The approximately $10 trillion that passes across borders each year is accompanied with a large chunk of fees.

This has opened up an avenue for fintech companies to mitigate the pains points of cross-border payments, by combining technological and financial prudence. These smaller firms work by setting up relationships with existing banks and aggregate transfers to cut costs.

Regulation Roadblocks

However, the landscape of the financial industry is unique in its multi-layered regulation and stringent penalties, and while traditional financial institutions have built the machinery of compliance teams and internal processes, new Fintech start-ups are unable to devote as many resources to these issues. Last year, after Revolut disabled a system designed to automatically halt transactions to individuals who matched against sanction lists, a whistle blower called out the company's method for flagging suspect payments, stating that they were “utterly inadequate.” While fintech firms seem to be lacking in compliance measures, brick and mortar banks are attempting to fight back the competition in technology by reevaluating their existing business models and developing strategies to embrace fintech innovation. In particular, they are leveraging their position as a one-stop shop for financial products and services to provide bundled goods, whereas current fintech companies can only provide specific and limited services.

Realizing the Financial Inclusion

Despite the drawbacks, fintech companies provide a fresh perspective in solving pertinent issues faced by the banking industry and have forced us to question the current establishment. The more accessible and affordable financial services offered by fintech are particularly promising for developing countries, where financial inclusion is a prominent challenge.

Consider the current lending system used widely by traditional banks, in which consumers are provided loans based on their credit score. By design, this process works against a large portion of the population who do not have a constant source of income, creating a large gap in the lending market that fintech firms are looking to capitalize. New ‘peer-to-peer brokerage’ services are now eliminating the need for credit scores by coupling consumers who want to lend with those who want to borrow. By pooling people together and aggregating credit-worthiness, these fintech companies are broadening access to financial lending services and paving the way for a more equitable industry.

> “The proliferation of new fintech start-ups requires us to review our regulatory framework and amend it to reflect the needs of the fintech environment.”

A Replacement for Big Banks?

There is undoubtedly a need for fintech companies, yet the question still remains as to how they will fit into the current climate of the finance industry. In December 2018, Revolut announced that it had obtained a banking license from the European Central Bank, enabling them to avoid disparate requirements in individual states where they conduct business. However, such a pursuit of banking charters dilutes the functional differences between fintech companies and traditional banks as it forces them to compete on similar terms. On the other end, banks are also courting new fintech companies, leveraging their disruptive capacities through partnerships to better serve their own clients.

However, neither of these approaches tackle the specific requirements and risks posed by fintech companies. The proliferation of new fintech start-ups requires us to review our regulatory framework and amend it to reflect the needs of the fintech environment, instead of expecting fintech companies to fit into existing buckets.

Recently, Revolut has been back in the news for a series of new allegations – investigations into its involvement with a national security threat. When the company started, it was heralded for its innovative business model and fast-paced growth. But now it is wading through multiple controversies, each of which could have been avoided if it had systematically identified and controlled its risks.

Fintech firms have proven to be forerunners in pushing innovation in banking, yet also face unique challenges that we are not yet equipped to face. By reinventing our regulations to effectively tackle up-and-coming fintech companies, we can ensure that innovation in the sector is sustained, and we can continue to transfer and receive money at the click of a button.

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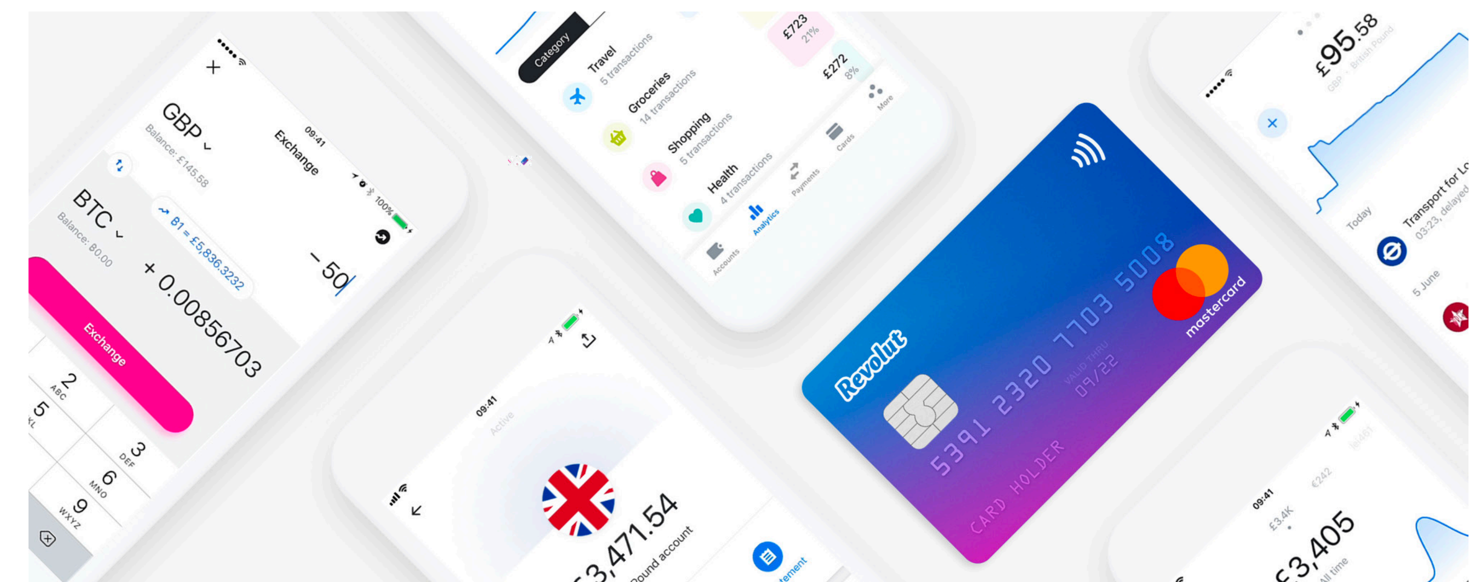

The Digital Dollar:

Amazon vs. All

ZACH MULLIGAN / BROWN UNIVERSITY

By the end of 2019, there will be more than 1.9 billion digital buyers all over the globe.[1] In developed countries like the US, there's scant chance of finding someone that hasn't used an online marketplace to buy something they wanted. Online marketplaces as we know them have been around since the 90s, and the industry's incredible growth is showing no signs of slowing down. Revenues across all of e-commerce are set to double by 2022, and that explosive potential is naturally attractive to new businesses hoping to cash in.[2] To be profitable, however, these new businesses have to overcome a huge barrier in the form of Amazon, a corporation that currently accounts for 38% of the e-commerce market.[3] While it may seem impossible for smaller marketplaces to compete against such a powerful player, Amazon's existence can push them to specialize in particular niches and take advantage of their small sizes in order to thrive in the market.

> "Thus, small companies may actually have the relative edge in a changing market."

Specialization

Amazon offers sellers a huge base of potential buyers, and can perform much of their logistics for a fee. For many buyers and sellers, there's no reason to go anywhere else. The question then becomes: What value can small marketplaces add to buyers and sellers' lives that Amazon can't? The answer is twofold. First, instead of trying to appeal to Amazon's established buyers and sellers, they can hone in on target markets in sectors that aren't easily reached by Amazon. For example, Society6 is an online marketplace devoted to independent artists and their fans. While a search for art on a large online marketplace might return some watercolor sets and mass-produced prints, Society6's specialization allows one-of-a-kind artists and their work to reach buyers specifically interested in what they have to offer. Its customer base grew 18% in the first quarter of 2017, which is a testament to its ability to bring in revenue from a niche base.[9] On the other hand, original art is an example of a market that Amazon can sometimes struggle to fill; the selection lacks somewhat in style variation and medium. By specializing and creating a sense of community between buyers and sellers in a specific sector, smaller marketplaces can find niches where they can thrive.

Innovation

Another path forward for small e-commerce is to innovate, which can be particularly facilitated by their size. While Amazon have massive revenue streams and market share, they have huge hierarchies that are often slow to utilize new strategies. Smaller firms can use their size to their advantage. For example, Jet, an e-commerce site launched in 2015, was able to try out a brand-new algorithm called dynamic pricing that gives shoppers larger discounts the more they shop. They're estimated to capture $20 billion in total revenue in 2020[4]. Another example of successful innovation is the 2010 startup Wish. They don't own warehouses or handle any stock; they simply serve as an intermediary that handles payments and connects producers directly to consumers. They also implement month-long delivery windows to cut costs further. The result is a fast-paced, hyper-cheap supply of products scrolling past the user in a Pinterest-like format. Wish proved so threatening that Amazon offered to acquire them in late 2015 for $10 billion, which Wish rejected.[7] While big companies certainly have the workforce to brainstorm and implement new ideas, the path from idea to concrete feature can be slowed due to their large sizes. Sweeping changes that could improve say, a pricing model during an unforeseen period of high demand, would affect a billion dollar revenue stream. Running an idea through various levels of bureaucracy will take time, meaning that opportunities to optimize or improve services may slip by. On the other hand, in smaller organizations, a higher proportion of employees have real decision-making power, and the decisions made affect a smaller total amount of revenue. Thus, small companies may actually have the relative edge in a changing market.

Impact on Big Companies

There is no doubt that primarily brick-and-mortar retail corporations have felt the heat from e-commerce. Many stores have struggled to adapt, with JCPenney and Sears facing bankruptcy scares earlier this year. While most of these companies only have websites to sell the same merchandise present in stores, Walmart, the largest retailer in the world by revenue, has decided to increase its level of competition with Amazon by buying the aforementioned Jet. Walmart is by no means a small enterprise, but its acquisition of the budding marketplace shows that Jet (in the minds of Walmart executives) has successfully made it to the grown-up table of e-commerce.

Why does it matter?

The growth of the online marketplace is not projected to end anytime soon as more and more people rely on digital means to buy goods or receive services. Competition has been the biggest driver of our modern free market, and the case is no different in the e-commerce industry. One of the core tenants of a competitive market is the entry of new firms, and these smaller companies can find success by specializing in niche areas and taking advantage of their sizes to innovate. The combination of progress and competition will benefit not just the most successful firms, but also consumers, who receive a cheaper, more efficient way to shop.

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