The 460th Convocation

Address: "What's So New about the New Economy?

By Austan Goolsbee

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Congratulations to our first M.B.A. class of the new millennium.

As some of you probably know, at the University of Chicago we have a tradition that the faculty graduation speaker gets uphere and talks about research.

I think we do this for two reasons: First of all, your spouses, parents, and siblings have not seen you for two years and they want to think you were doing something productive (rather than goofing off, which is what you were really doing). But more importantly, I really think we purposely want to get you bored, hot, overdressed, with a painful chair digging into your back, wondering to yourself when is this going to end—just to remind you one last time exactly what it's going to be like out there in the real world.

But let me reassure all of you graduates here today that my speech is going to be shorter than the GSB Follies were. In fact, my wife is in the audience and she's due to have a baby at any moment. So if she stands up and gives me the signal, this is going to be a really short speech.

Today I thought I would talk to you about the new economy. Many of you here are not M.B.A.'s and I'm sure you have looked around and seen the boom—the productivity growth, the stock market, the nose-ringed billionaires proliferating around the country—and I'm sure you have wondered to yourselves, "What happened? Is this going to continue? Are these companies worth the money?" Our M.B.A.'s already know the answers to these questions, but I today I thought I would give you the six-minute-crash–M.B.A. in electronic commerce. This will pretty much make you an expert, though, since our graduates with their TV-fueled childhoods may only remember about six minutes of their course work, anyway.

To help them remember it, I have invented a framework like the four P's or the three C's. I call it the S, V, J, B, and an F.

S is for the Start.
To start, the evidence is quite clear that the Internet cannot explain the ongoing boom in the country. The Internet accounts for 0.6 percent of total retail sales and an even smaller share of business-to-business sales and it cannot explain why we have had so many years of growth with no inflation. Productivity growth from major innovations takes a long time. The research shows that electricity, computers, and other major disruptive innovations took decades before they had effects on productivity growth.

Not only that, we have to wonder about how much the Internet is really going to raise worker productivity when we see things like the Amazon.com bestsellers listed by company for one of this country's leading firms. I think number 1 was *The Idiot's Guide to Day Trading* and number 2 was

Quit Your Job Often and Get Big Raises.

So if you ask whether the Internet is going to make us more productive, in the short run, the answer is probably "no." But let's admit that it is going to make life so much more enjoyable. At how many boring meetings, for example, will it look like we're taking notes when we're actually playing games on our Palm Pilots?

The second point is V for Valuation.
Any of you not familiar with Net Present Value might look at the stock market valuations of these Internet companies and say: "Can these Internet companies

really be worth that much? Can a company with a price/earnings ratio of a thousand or even no earnings whatsoever still have a value? That has to be insane."

Well, as our M.B.A.'s know, the value of a company is the present discounted value of all of its future profits. So the *E* today in the *P/E* ratio doesn't matter. What matters is what the *E* is going to be in the future. A company can make no money today and still be worth something. It can make no money for ten years and still be worth something (although it needs to be discounted!). But if it announces that it is never going to make any money, it isn't worth anything. In the end, the valuations of these companies will be justified only if at the same level of volume they could either get higher prices than the existing companies get or their costs are lower than those of the existing companies.

That brings us to point J, which is Junk Mail.

The future of the new economy will be driven by junk mail. The fact is that by using the data that they gather on you every time you sign on to tailor the product, send you coupons, and give you prices that are targeted just for you, they're hoping to get higher prices than they could from a random person who just walks into the bookstore off the street. I often wonder why people are so concerned about some hacker stealing their credit card number if they use it online when, in reality, the far more damaging information is what goes to the merchant itself. They're the ones who are going to be charging you more money. They don't need to steal your credit card to get it.

Advertising is another type of this same approach. You want to tailor the product for some very narrow group of people. A lot of companies based on advertising will never make any money, but some will. The networks on television have made their businesses without charging the consumers directly and some dot coms could do the same thing. The more tailored it is, the better for advertisers.

However, the good news from the consumer's point of view is that most of these companies aren't very good yet at taking account of which things are tied with what and charging different prices based on it. I've tried desperately for the last year and a half to explain to Amazon that the three-volume set of Winston Churchill's biography that I purchased was *a gift for someone else*. I have no inherent interest in Winston Churchill. Yet, I receive e-mail after e-mail offering me auctions of Churchill's cigar and every other Churchillian item you can imagine.

The Internet is making it easier to gather information on consumers and price discriminate. On the opposite side, the Internet is also giving powers to the consumers to fight back: search engines and shopping bots, group buying and privacy laws. The question is going to be whose technology is improving faster, the consumers' or the producers'? So far, the evidence points to the consumers. If you believe, to the contrary, that the producers are going to win and that people are actually going to pay significantly more for convenience and aren't going to be price-sensitive in their online purchases, you had better first take a look at the evidence on online buying patterns before you go out and buy stock in Internet retailers.

B is for Barriers to Entry.

If there are no barriers to entry, there are no profits and you're out of luck. One of the most basic principles of a market economy is that just because a lot of consumers value something doesn't mean that anyone is going to make a large profit producing it, because a lot of other people will be trying to do the same thing. People might be willing to pay a lot for something if they had to, but they don't have to because competition drives price down to approximately the cost of producing the thing. That means that if you are going to be one of the currently nine online pet-food selling companies with no way to prevent new ones from entering, you probably won't make much money. If you are a company that has network externalities, large switching costs, and lower operating costs, then at least you have a chance. But the entry process is perhaps more ruthless than people generally imagine. I heard about a class at Harvard's business school this year for which the final project was to write a business plan. The sum total of projected advertising revenues from the business plans in this class exceeded the sum total of advertising in the entire United States last year! Obviously if that many people try to get advertising, advertising rates are going to fall.

The fact is that if the fixed costs and the entry costs are low, an industry may be great for consumers but there will not be much profit for the people making these products.

The final is F, for the Future.
The best thing and the most difficult thing about the new economy is that it doesn't come with an instruction manual. Those of us doing research on it are waiting for you to do something so we can study it. So I'm begging you, do s*omething* because otherwise we're out of our jobs!

But if, wherever you're going, you one day find that you need inspiration, let me just tell you that I have a dream.

I dream of a world where the technology will be so advanced that the cell phones will turn themselves off when a person goes into a movie, so as not to interrupt us.

Where day traders will realize that bargains are efficient and go into index funds.

Where no one will have to receive junk emails of crummy recycled jokes from their friends, and where no website will have it set up so that as soon as you go there it opens five different windows, none of which you are interested in and none of which you can hit the "back" button from.

I dream of you returning to a glistening new business school campus in five years with Hyde Park having become the information economy metropolis that it is just on the threshold of becoming.

I dream that each of you will appear on the cover of the *Wall Street Journal*—or at least in the alumni section of Allan Friedman's GSB notes.

No graduation speech would be complete without some advice. My advice is quite straightforward. God gave you two ends: One to think with and one to sit on. Your success in this world is determined by which of those ends you use the most.

Frankly, 80 percent of this world doesn't care about your problems and the other 20 percent are glad. They don't care that there are 697 University of Chicago M.B.A. graduates ready to reshape the economy and rebuild it. In fact, in one year there are going to be thousands more M.B.A.'s around this country and around the world who are intent on taking your places. That's the bad news. The good news is that you have a one-year head start.

So get out there and make it happen. I would say "be yourself," but for some people "be yourself" is about the worst advice you can give. So instead I will tell you this: Never forget where you came from and never commit the sunk cost fallacy.

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