Equity Research

North America

Deutsche Banc Alex. Brown

Deutsche Bank

#48 The Baby Boom Chart Book 2000

#49 How To Value Earnings Growth

#50 Living La Vida Loca

#51 Age Wave Is Still Bullish For Stocks

Topical Study #52

Is New Economy Going Global?

❖

Dr. Edward Yardeni

Chief Economist
& Global Investment Strategist

August 7, 2000

www.yardeni.com

I. Power To The People!

The end of the Cold War marked the beginning of a dramatic global transfer of power from governments to consumers, taxpayers, and shareholders. During wartime, power obviously needs to be concentrated in the government. We are all patriots and we want the government to win the war. Favored producers and trade unions often share some of the government’s wartime powers through measures aimed at reducing competition including subsidies and sweetheart contracts.

During peacetime, this concentration of political power is no longer justified. Economic power becomes more important than military might. The producing interests need access to foreign markets, i.e. foreign consumers, to thrive. Therefore, they put pressure on their government to open up those markets through free trade negotiations. Free trade increases global competition for global consumers.

Competition empowers consumers as producers around the world scramble to win their business by offering the best goods and services at the lowest possible prices. To do so, businesses must 1) cut costs, 2) increase productivity, 3) innovate, and 4) distribute globally.

II. The Innovation Imperative

Increasing productivity boosts consumers’ real incomes, thus giving them even more economic power. In a competitive market, producers struggle to maintain their profitability. Profit margins are mostly mediocre as a result of competitive pressures, so producers have to try to sell more units to maintain enough profitability to remain in business. However, profits will be much stronger for innovators, i.e., producers and entrepreneurs who offer consumers something new and better. But, in competitive markets highly profitable innovations can become commodities with low profit margins very quickly. So the pressure to innovate constantly is intense.

As I have observed many times in the past, the New Economy is driven by an old paradigm, not a new one. The old paradigm is the competitive market model. The New Economy consists of companies that are very profitable innovators. The Old Economy consists of much less profitable commodity producers.

III. Tax Cuts Globalizing New Economy

In the United States, the government started to shift power back to consumers before the end of the Cold War. At the start of the Reagan administration, marginal tax rates were cut dramatically. There is a growing recognition around the world that giving consumers more power in this way is essential for the development of the New Economy.

In Germany during July, Chancellor Gerhard Schroeder successfully engineered a new tax reform package very much in the Reagan tradition. Marginal income tax rates will be reduced. The tax revision also rids corporate Germany in 2002 of capital gains levies, unique to the country, that limit the ability of companies to sell off major blocks of shares and hinder restructuring.

Germany's stock market moved higher earlier this year on news that the government was promoting tax reform. The DAX index hit a high of 8064 on March 7, 2000, and subsequently corrected to its 200-day moving average around 7000 recently. The German stock market is likely to move higher as earnings expectations continue to improve along with business and consumer indicators (Exhibits 1-5).

President Jacques Chirac of France responded to the German tax reform package by calling for tax reductions in France as well. In May, the new finance minister, Laurent Fabius, said that the tax burden is "too high" and vowed to "increase the movement toward tax reduction."

In Canada, the government is providing the deepest tax cuts in its history over five years. This is in response to a rare budget surplus and to persistent complaints that the country is losing some of its smartest workers to the US, where business and income taxes are generally lower.

Mounting budget surpluses in most of the industrial economies are providing the financial cushion for tax cuts. There is also a growing belief among policymakers in the supply-siders' prediction that lower marginal tax rates stimulate economic growth and total tax revenues.

IV. Other Necessary Conditions

Tax cuts are not the only precondition for the development of the New Economy around the world. Following his tax revision victory, Mr. Schroeder observed that other reforms are necessary to strengthen Germany's competitive position. He intends to press forward with labor market reforms now, starting with pensions.

In a July 17 cover story in the *International Herald Tribune,* John Vinocur wrote:

> In a sense, tax cuts are the easy part of the European economic reform equation because, in comparison with pensions, health and job protection, they make smaller demands on the predominantly Social Democratic sensibilities of European governments and do not represent a direct challenge to many Europeans' view of national cohesion.

He then observes that even Fed Chairman Alan Greenspan believes that relatively high labor costs rather than taxes explain why Europe and Japan are not benefiting as much from the New Economy as the United States. In a July 11 speech, Mr. Greenspan said, "The rates of return on investment in the same new technologies are correspondingly less in Europe and Japan because businesses there face higher costs of displacing workers than we do."

V. Stealth New Economy In France

Perhaps one of the biggest surprises out of Europe is that France is actually leading the way toward the New Economy. Let's review the recent press clippings:

1) *International Herald Tribune* (April 29-30): "France Reforms on Sly (But Shh! It's a Secret)." According to this story, a "quiet revolution in the labor force is fueling economic growth that is the envy of France's neighbors and promises to drive down the unemployment rate to levels not seen in a decade." While issues such as high taxes and the new 35-hour workweek grab the headlines, beneath the surface the labor market is actually becoming much less rigid. This story notes that French productivity is up to 108% of US workers'.

2) *Fortune* (June 12); "The Next French Revolution." The French gave us the word "entrepreneur," but have made life very difficult for this class. The article states, "Now a third revolution may be brewing. There is a burgeoning class of rebels with an outlook that embraces the globe, not just France or Europe. These rebels favor individual enterprise."

3) *International Herald Tribune* (July 10): "Glory Wears Off a French School—Young Prefer Business to Politics." The National School of Administration has been shaping top students for government with enormous success. Now top students are increasingly interested in studying engineering and business to prepare for jobs in the New Economy rather than in the old government. A recent survey of students in a dozen of France's best schools found that about 12% wanted to start their own companies as soon as they got out of school. Another 40% wanted to start one sometime in their life. A few years ago, there was little such interest found by the pollsters.

4) *International Herald Tribune* (August 2): "France Proposes Savings System." Finance Minister Fabius recently proposed an employee savings plan to help workers prepare for retirement. The voluntary plan would allow employees to set aside up to a quarter of their pay for a minimum of 10 years. The funds would be subject to a 10% social security tax when withdrawn, but would be exempt from all other taxes. The plan will be presented to Parliament in October.

The French economy is one of the best performing ones in Europe at this time. Industrial production is up 4.6% over the past 12 months. Stock prices continue to rise into record territory along with earnings expectations (Exhibits 6 and 7).

VI. Mexico Thrives In NAFTA

One of the most impressive beneficiaries of the New Globally Competitive Economy is Mexico. The country's economy has benefited greatly from the North American Free Trade Agreement (NAFTA). Increasing trade with the United States and Canada contributed to Mexico's rapid recovery from the 1994 peso crisis. Freer trade also unleashed political forces, which undoubtedly contributed to the democratic overthrow of the Institutional Revolutionary Party, the longest ruling political party in the world. The new leadership under President Vicente Fox has pledged to work hard to reduce corruption. The new president is also very committed to integrating Mexico's economy even more closely with the United States and Canada through NAFTA (Exhibits 8 and 9).

VII. Clueless In Tokyo

I suppose that with the political upset in Mexico, Japan's Liberal Democratic Party (LDP) is now the oldest ruling party in the world. The LDP deserves a great deal of credit for the revival of Japan after World War II. But they also deserve the blame for Japan's horrible economic performance since the early 1990s. Rather than jumping aboard the New Economy bullet train, they've chosen a discredited Keynesian policy mix of profligate fiscal spending with zero interest rates. Moreover, they've done nothing to root out corruption.

As a result, Japan's economy remains in a rut. Stock prices are falling again. Real GDP is up a meager 0.7% from a year ago. Deflation is a serious problem in Japan. The GDP price deflator is down 1.7% from a year ago. Interest rates are close to zero, but they are still higher than the growth rate of nominal GDP, which is currently minus 1.1% (Exhibits 10-13).

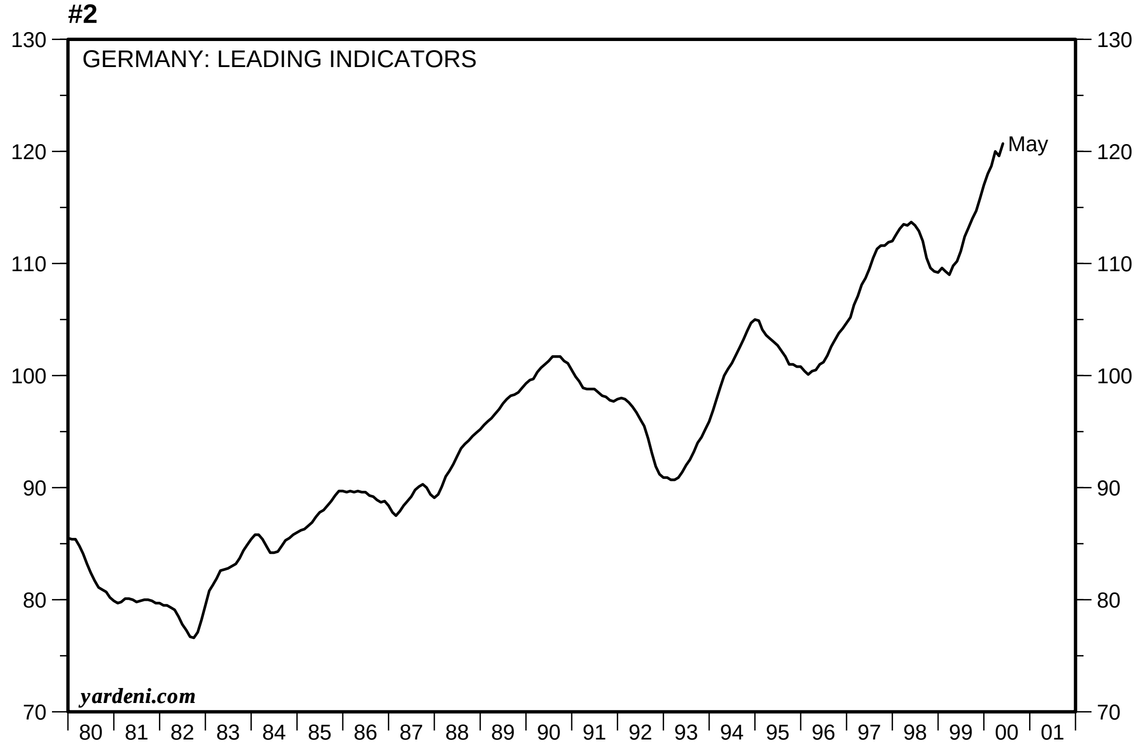
- Germany -

Export boom and tax cuts bullish for German stocks.

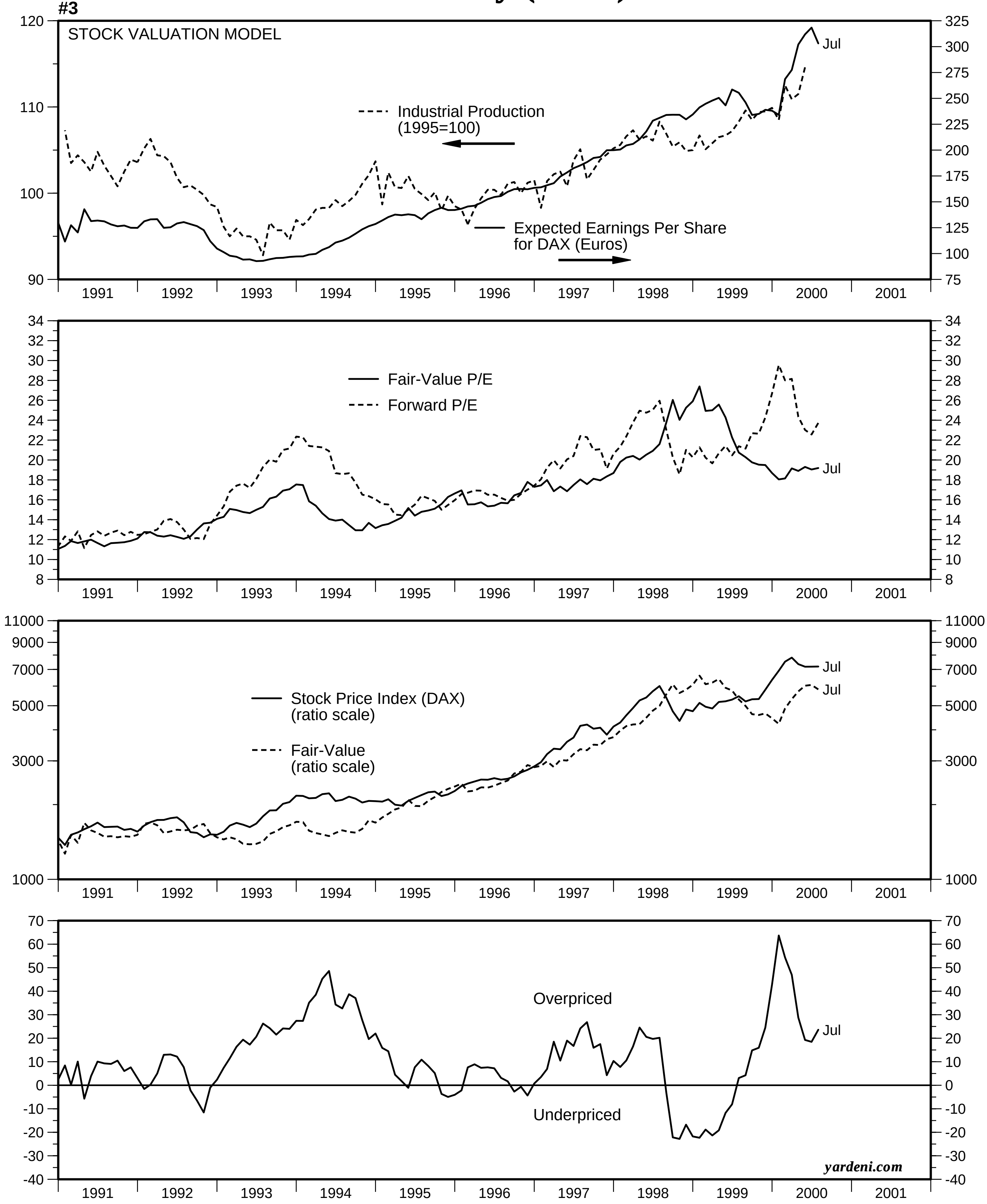
#1

German leading indicators at record high.

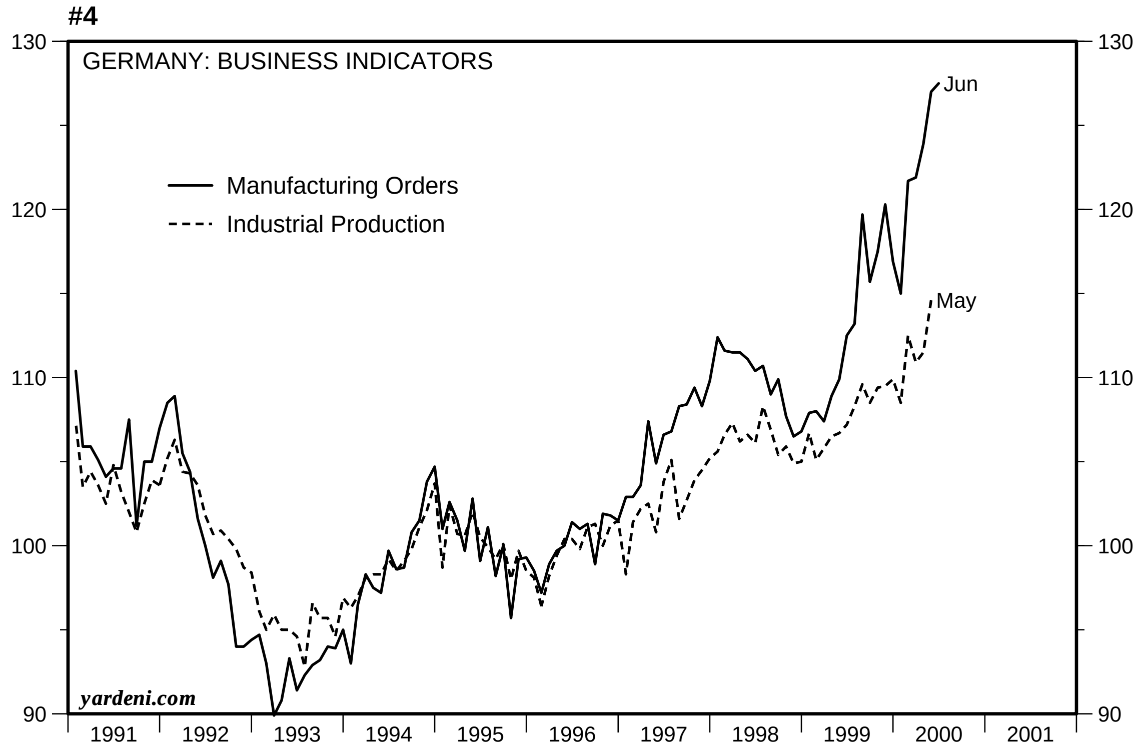
#2



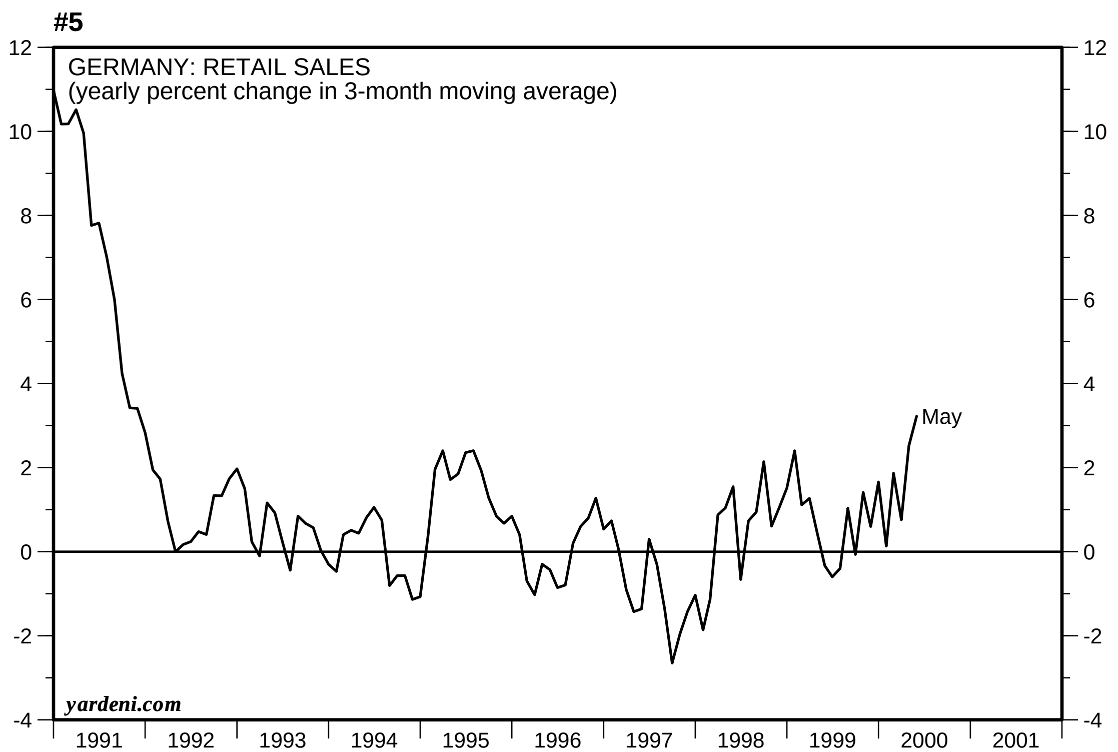
- Germany (DAX) -


#3
STOCK VALUATION MODEL
Industrial Production
(1995=100)
Expected Earnings Per Share
for DAX (Euros)
Jul
Fair-Value P/E
Forward P/E
Jul
Stock Price Index (DAX)
(ratio scale)
Fair-Value
(ratio scale)
Jul
Jul
Overpriced
Underpriced
Jul
yardeni.com
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001

- Germany -

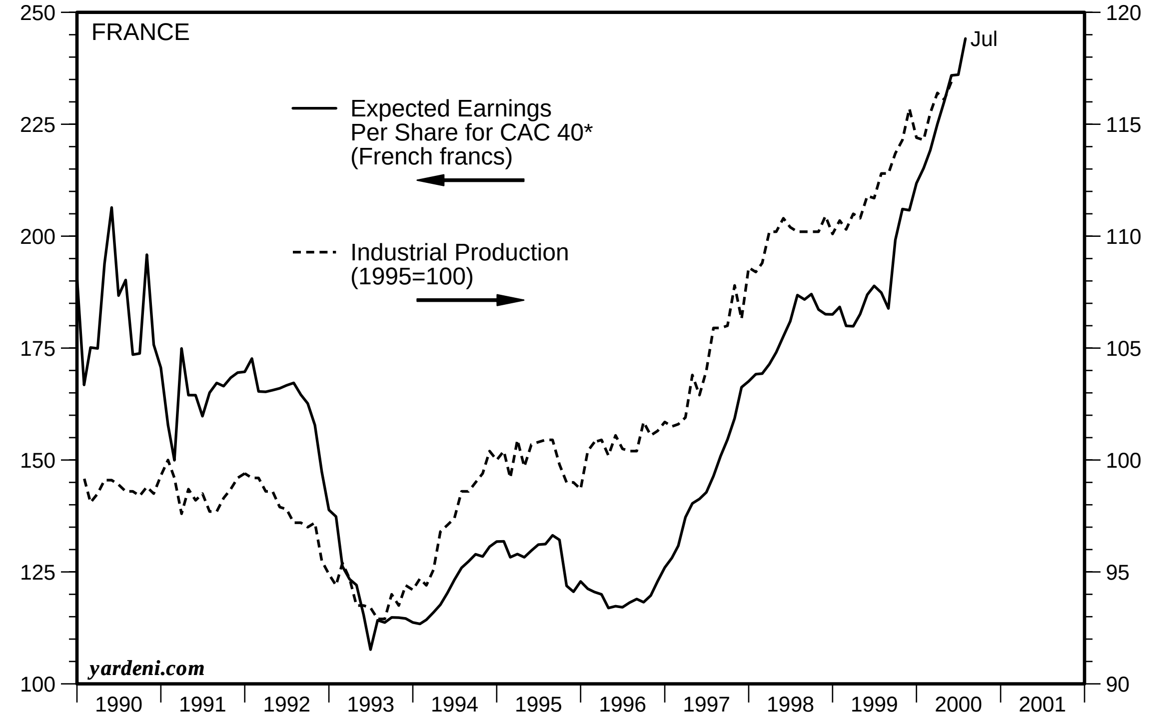


Everything is looking up in Germany. Except retail sales, which should improve as jobless rate falls and tax cuts boost consumer confidence.



- France -

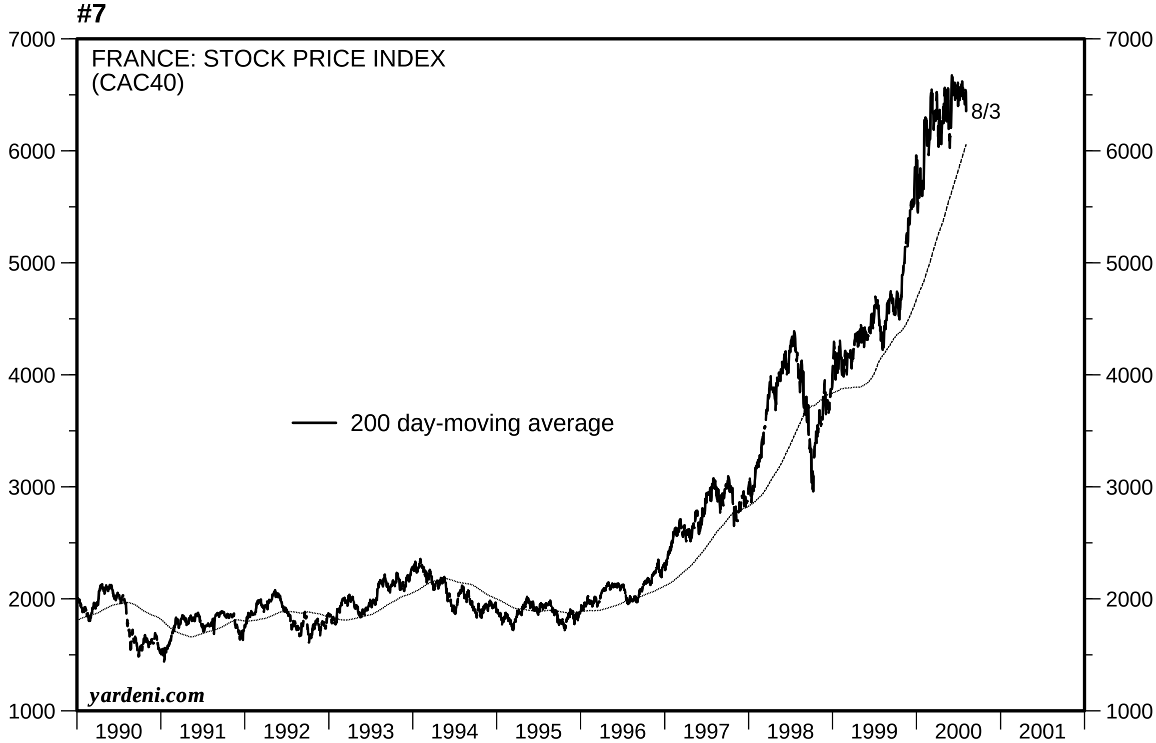
#6



* Consensus bottom-up 12-month forward earnings.
Source: I/B/E/S International Inc.

Viva la France! The economy is booming and so are earnings expectations and stock prices.

#7



- Mexico -

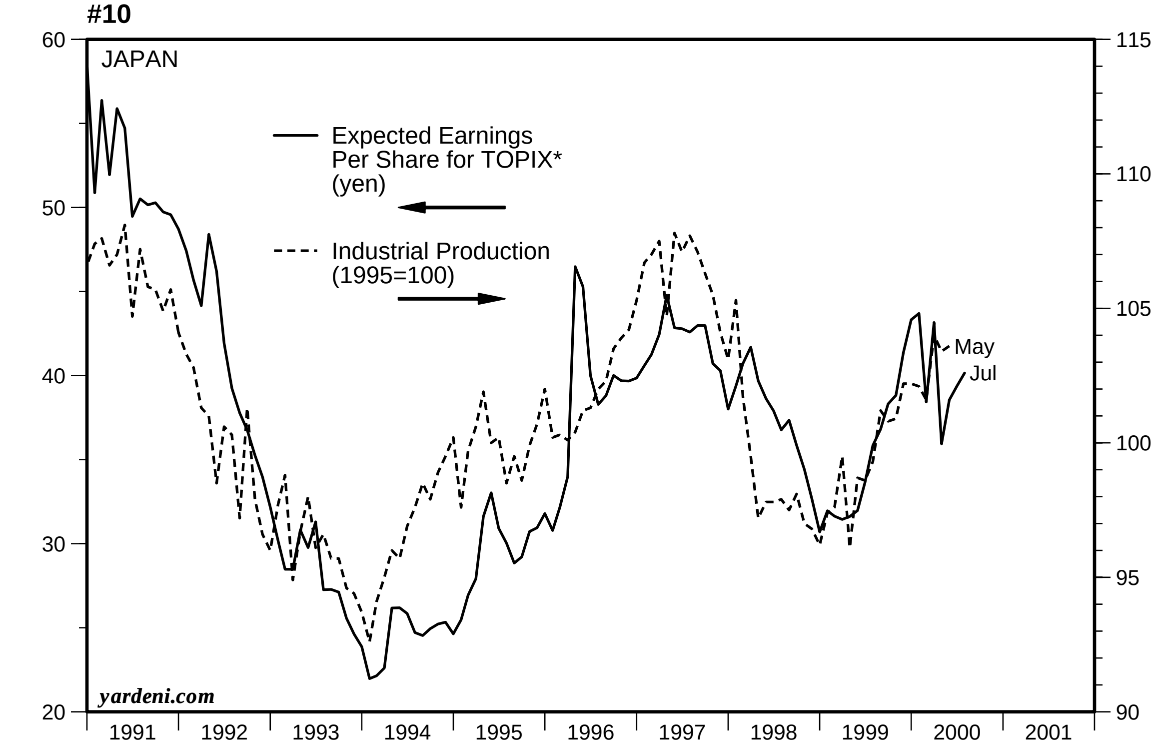
#8

Mexico's economy is benefiting greatly from NAFTA.

#9

- Japan -

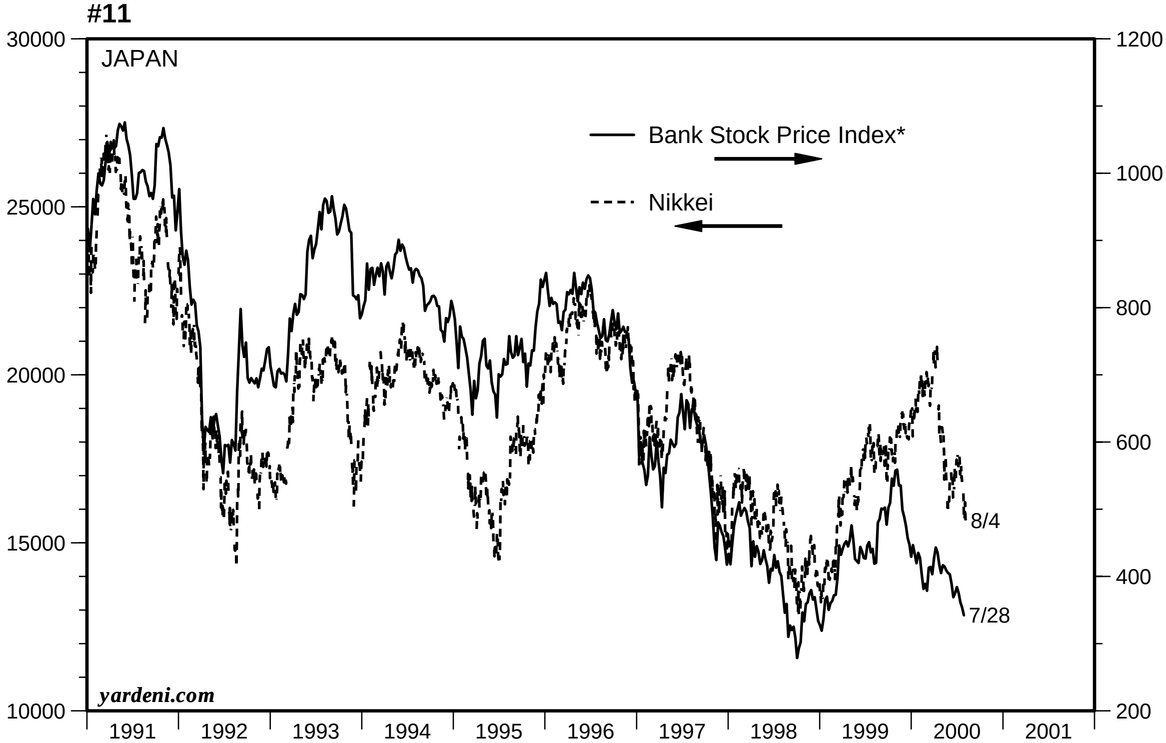
#10



In Japan, earnings expectations remain subdued for stocks suggesting limited upside for production recovery.

* Consensus bottom-up 12-month forward earnings.
Source: I/B/E/S International Inc.

#11

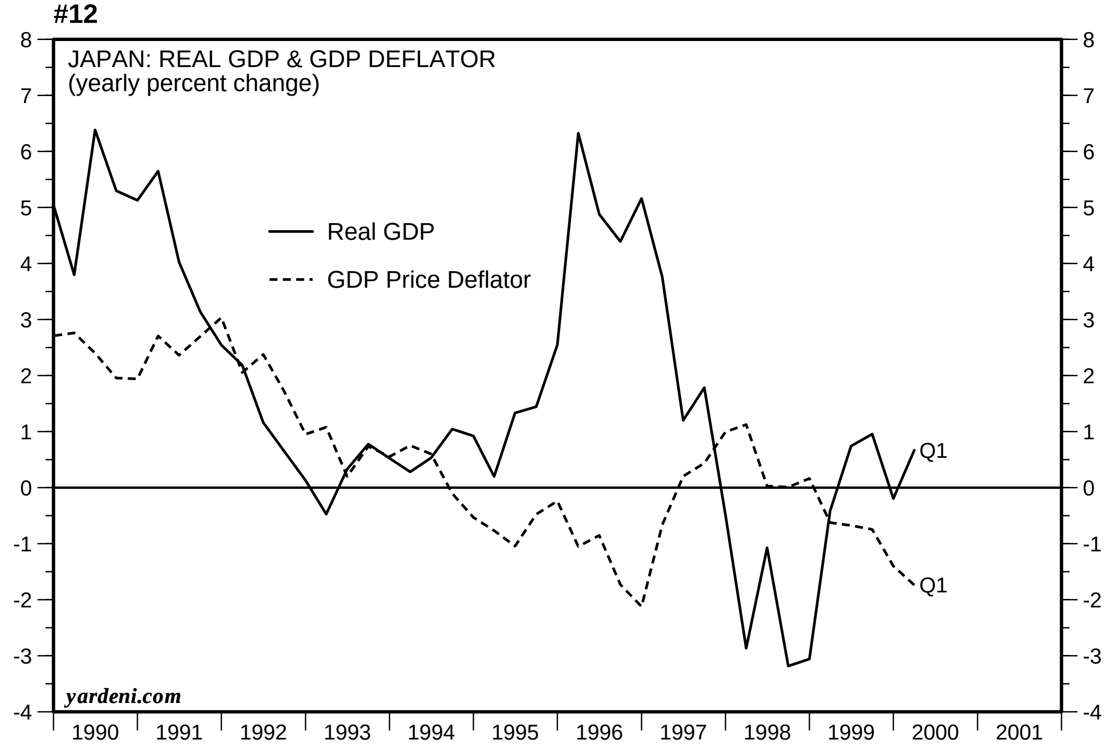


In Japan, very weak bank stock price index is bad news for overall market.

* Bank share price index covers stocks that are listed on the Tokyo Stock Exchange.

- Japan -

#12



In Japan, real GDP growth is close to zero. Deflation is a problem. Interest rates may be near zero, but nominal GDP growth is negative.

#13