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Securities

TOPICAL STUDY #8
NO SHORTAGE OF GLUTS

Economics

Dr. Edward E. Yardeni July 10, 1985

Many economists believe that the strong foreign-exchange value of the dollar is the main reason why the U.S. industrial, agricultural, and mining sectors are depressed. A flood of cheap imports is threatening to swamp the goods-producing core of the U.S. economy. Economists note that the flip side of the mounting trade deficit is a growing dependence on foreign saving; the U.S. is becoming an international debtor for the first time since 1914.

This dependence makes us vulnerable because if foreign savers move their funds elsewhere, the dollar could tumble. This could restimulate inflation and cause interest rates to soar.

Not a very happy set of alternatives: If the dollar remains overvalued, the trade deficit will sap the vital juices of our goods-producing industries and could trigger an economy-wide recession. If the dollar tumbles, reflation and higher interest rates could also lead us into a recession.

Politicians warn that "something must be done to bring the dollar down" or else the pressures to impose protectionist measures will become hard to resist. The Federal Reserve has responded by lowering interest rates. The Fed cut the discount rate three times since November 1984, from 9.0% to 7½%. And yet, on a trade-weighted basis, the dollar was 2.8% higher during the week of June 12 than during the week of November 21, 1984 just before the Fed cut the discount rate from 9% to 8½%.

How did we get into this predicament? We believe that the strong dollar is not the root cause of our worsening trade deficit, or our crumbling industrial base, or our mounting farm crisis. Rather, all these unfavorable developments are the result of a massive structural economic change: *the shortages of the 1970s have evolved into the gluts of the 1980s.*

During the 1970s, inflation was fueled by a widespread perception that many key commodities and real assets were in short supply. To name but a few: crude oil, strategic metals, farm land, and Park Avenue co-ops. At the time, these shortages were viewed by many as structural or even permanent, so how could you lose by betting on higher and higher prices?

Greed fueled by the promise of incredible returns encouraged speculators to leverage their bets by borrowing. People were willing to incur excessive debt because interest costs seemed cheap relative to the potential gains to be had through speculation. The shortage mentality which proliferated during the 1970s induced many individuals, companies, and countries to commit huge sums of capital to exploit and produce those assets that appeared to be in short supply. Initially, this trend tended to exacerbate the perceived shortages.

The Great Inflation of the 1970s stimulated market and policy responses which converted the shortages into gluts and created dangerous deflationary forces in the 1980s.

In the 1970s, as inflation intensified, the ranks of the borrowers swelled, while the ranks of the savers thinned out. Those who remained savers demanded a fair market interest rate which compensated for inflation. They were much less willing to keep their funds in passbook accounts. Entrepreneurs responded by inventing money market mutual funds.

As money flowed out of thrift deposits, which were subject to Regulation Q rate ceilings, into higher yielding Treasury securities and money market mutual fund shares, the regulators of depository institutions were placed under intense pressure to "save" the housing and thrift industries. The response was deregulation; Regulation Q ceilings on deposit rates were phased out.

The Federal Reserve Board fueled the Great Inflation. Prior to 1979, the Fed's response to inflation was reactive, rather than preventative. Under the interest rate targeting approach, the Fed tended to raise interest rates after inflation rose to a higher level. As a result, inflation had a definite upward bias because the Fed's response was more often than not too little, too late.

Since October 1979, the Fed has pursued a more monetarist approach that tries to anticipate inflationary pressures by controlling the money supply. Paul Volcker, who became Fed Chairman in July 1979, wasn't a monetarist. But he was committed to bringing down inflation. By shifting the Fed's operating procedures toward control of the money supply, he was able to sit back and let interest rates rise dramatically to levels that would do the job. He constantly deflected political pressures to lower interest rates by claiming that the Fed controlled the money supply, not interest rates. (The drop in rates during the Mexican debt crisis of the summer of 1982 proved that the Fed could bring rates down to avoid a world financial debacle.)

All of these market and policy responses to the Great Inflation pushed interest rates up to levels that ultimately turned good inflation bets into illiquid, deflated disasters, e.g., oil rigs, farm land, and loans to Argentina. High rates also put a tremendous strain on thrift institutions as their deposit costs soared (thanks to deregulation) while their return on assets was held down by single-digit fixed-rate mortgages. Some tried to catch up by earning an extra 25-50 basis points on funds naively invested with such store front operations as E.S.M. Government Securities and Bevill, Bresler & Schulman Inc.

In addition to high interest rates, the dramatic rise in the foreign-exchange value of the dollar from 1980 to 1984 was also an important market development which created tremendous deflationary pressures. Like high interest rates, the mighty dollar also has its roots in the Great Inflation. In the 1970s, many LDCs bet on inflation by borrowing huge sums of dollars from U.S. banks to exploit their natural resources. The total indebtedness of non-OPEC developing countries rose from $290 billion in 1977 to $700 billion in 1983, much of it dollar-denominated. In effect, they took a "long" position in real assets and a "short" position in the dollar.

The international debt crisis started early in the 1980s when interest rates soared above inflation. Suddenly, interest costs rose above projections while revenues fell below expectations as commodity prices collapsed. The dollar flood turned into a trickle. LDCs that were used to having more dollars than they needed now desperately scrambled to cut their imports and boost their exports to earn the dollars to service their debts. The foreign-exchange value of the dollar soared as U.S. capital outflows (primarily U.S. bank loans to overseas customers) plummeted from $119 billion in 1982 to $21 billion in 1984.

The international debt crisis forced many developing countries to impose austerity economic measures and at the same time to dump commodities in the world markets to earn badly needed foreign exchange. And, because speculators and investors added capacity year after year to produce the goods which seemed in short supply, the world economy is today suddenly flooded with more products than can be readily absorbed. *Globally, there is just too much productive capacity.*

In other words, the shortages of the 1970s evolved into the gluts of the 1980s. This process more than any other development helps to explain the rapid decline in inflation. It helps to explain why the U.S. industrial sector is currently in a recession. It suggests that U.S. farmers would have gotten into trouble even if both the dollar and interest rates were a lot lower.

The conclusions are obvious. As long as the gluts persist, inflation isn't coming back. Interest rates should continue to fall. The risk to lowflation is deflation, not reflation. The U.S. industrial, agricultural, and mining sectors will remain depressed even if interest rates decline further. Protectionist sentiment will grow as a political force.

Is deflation an inevitable consequence of the Great Inflation? Some economists argue that the Fed will avert deflation by reflating. But they warn that the deregulated credit markets are full of vigilant investors who might respond by pushing interest rates up so fast that reflation could quickly turn into deflation. This is a chance we believe the Fed must take. We aren't advocating a policy of reflation. Rather, we favor a policy of lower interest rates. With so many deflationary pressures, we think that the risk of triggering another Great Inflation are minimal.

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