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#23 The End Of The Cold War Is Bullish

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Topical Study #27

10,000 In 2000

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Dr. Edward Yardeni
Chief Economist

I. The New World Economic Order

A Major Event. The end of the Cold War was a major event in world history. We all immediately recognized it as such. I am not sure we yet understand the full impact of this historic event on the global economy. I’ve been thinking and writing about the subject from time to time since before the Berlin Wall came tumbling down.

In my Topical Study #15: *The New Wave Manifesto*, dated October 5, 1988, I predicted that "market capitalism will continue to proliferate and flourish in the global economy." On August 1, 1989, in #17: *The Triumph Of Capitalism*, I predicted the disintegration of communism. The Berlin Wall was dismantled during November 1989. I followed up with #19: *The Triumph Of Adam Smith*, #20: *The Collapse Of Communism Is Bullish,* and #23: *The End Of The Cold War Is Bullish.*

I believe that the global impact of the end of the Cold War was mostly disinflationary for industrial economies. The disinflation trend is especially strong in the United States. Of all the major industrial economies, the US seems to be adjusting best to the competitive pressures unleashed by the end of the Cold War. The restructuring of the American economy has proceeded very smoothly compared to Japan and Western Europe. If we continue to increase the efficiency of our economy by cutting production costs and reducing the cost of government, other countries will be under enormous pressure to do the same.

I predict that US inflation will be near zero within the next 12 months. In the *short term,* this would be bad for profits and stock prices. I even see a 25% chance of a mild recession during the first half of 1996. But, I also predict that inflation will remain near zero through the end of the decade, and the *long-term* consequences of this scenario are extraordinarily bullish for financial assets, i.e., both stocks and bonds. The long-term government bond yield should fall to 5% by the end of 1996 and perhaps as low as 4% by 1998. The Dow should soar to 10,000 by the year 2000. The correction I expect to see over the next few months should create plenty of opportunities to buy good stocks at lower prices before the next big move to the upside.

The Capital Shortage Myth. After the Berlin Wall was turned into souvenir-sized rubble, many economists predicted a global capital shortage. Instead, interest rates fell sharply during the early 1990s around the world. The global capital shortage scare was revived for a brief time last year when bond yields soared in the US and Europe. It was feared that emerging economies would attract a great deal of capital, drive up commodity prices and inflation, and permanently raise real interest rates in the developed world.

The shelf life of this upsetting scenario was about half a year. It blew up when Mexico blew up financially at the start of 1995. For many emerging markets, the speculative boom–which was fueled by large capital inflows from the United States, Europe, and Japan–turned into a miserable bust.

Mexico's financial debacle caused many American investors to conclude that the best way to invest in Mexico and other fast growing but volatile economies is to buy coke. No, not the drug, but Coke, the multinational soft drink giant. Buy the stock and let the Coke folks worry about political instability and exchange rate risk while selling lots of soda all over the world.

Without the stimulus of speculative foreign capital, the emerging markets lose much of their potential for inflationary mischief at the global level. Of course, that doesn't mean that they aren't capable of creating some home-grown inflationary and speculative excesses, as can be seen in China, for example.

Adam Smith's Insight. On balance, the end of the Cold War is disinflationary rather than inflationary because it dramatically increased the supply of cheap labor. That's obvious. *Less obvious is that the dramatic increase in the number of consumers around the world is an even more powerful source of disinflation.*

How can this be? Wouldn't more consumers put more upward pressure on global prices? In a word: No. More than 200 years ago, Adam Smith, the greatest economist of all time, explained that the bigger the market–assuming reasonably free trade–the lower the prices for consumers. Big markets offer a powerful incentive for profit-motivated producers.

In a free market, especially a big one, there is bound to be a glut of producers all hoping to get very rich. The successful ones will be those that offer the best quality and service at the lowest price. The successful ones must necessarily be the low-cost producers. In a huge global market with lots of actual and potential competitors–many having ready access to cheap labor–the pressures to cut costs and increase productivity are enormous and unrelenting.

What is true for producers is also true for countries in the New World Economic Order. Countries that offer the global market the best quality goods and services at the lowest cost will prosper. Those with high costs will fall behind. Economies with rigid labor markets and rigid regulations won't adapt to the global market as rapidly as they must to compete against countries where producers have more flexibility.

Next, I will examine how well different countries have adapted to the New World Economic Order.

II. US: Baby Boom Backlash

Americans Are Movers. Of all the major industrial nations, the United States has responded best to the challenges of the post-Cold War world. That's mostly because labor markets have become more flexible in the US; they remain relatively rigid in Europe, and very much so in Japan.

American workers tend to be more mobile than their European counterparts. They are willing to move very far within the United States to find employment. Between March 1993 and March 1994 nearly 43 million Americans moved, with nearly 7 million of them moving to a different state. They accept the fact that job security no longer exists. When they move to a new job, they accept lower wages and benefits. Instead of automatic raises each year, more of workers' pay is in the form of incentives and profit-sharing.

Labor unions have lost membership and power in the private sector. The situation is so desperate that three of the once mightiest unions–the United Steel Workers of America, the International Association of Machinists and Aerospace Workers, and the United Auto Workers–earlier this year agreed to merge. However, their goal is to do so five years from now!

Most American workers are probably working harder than they did five or ten years ago. They have less job security. Many may be earning less and have fewer benefits. Yet, even with the unemployment rate down to 5.5%, most Americans seem content just to have a job. To stretch their incomes they are shopping at discount stores. They seem to understand the importance of keeping costs down to keep the economy competitive and to keep their jobs.

Newt. They also seem to know that a large federal deficit, open-ended social welfare programs, and high taxes aren't good for the competitive position of the United States. They increasingly are inclined to set limits on the role of the government in the economy. They made this quite clear during the November 1994 elections.

As a result of those elections, Newt Gingrich became the leader in the House of Representatives. He and his fellow Republican supporters in Congress derive their power and their mandate from workers, especially the Baby Boomers. These constituents are the political force behind the push to put some real limits on the social welfare state before it becomes completely bankrupt just in time for their retirement.

The Democrats are in disarray. They lost their stranglehold on Congress after the Republican sweep in last year's Congressional, state, and local elections. They continue to lose power:

1) For the first time since 1948, Democrats now hold fewer than 200 seats in the House of Representatives, and eight of 15 Democratic senators up for re-election are not running, including Bill Bradley and Sam Nunn. This is the highest number of retirees from one party in Senate history.

2) For the first time in 40 years, Republicans now control a majority of state legislatures.

3) In the 1950s, 73% of voters in union households said they were Democrats: Now only 45% do.

The Democratic Party represents the government: It's biggest supporters are either people who work for the government or who benefit from government programs. In this sense, it is the Party of the Government. The decline of the Party parallels the diminished status of the federal government among the American citizenry in general and the Baby Boomers in particular.

If the Gingrich Republicans' initial assault on the American welfare state is successful, they will undoubtedly be emboldened to move forward with their agenda. More specifically, they might turn their energies toward replacing the current tax system with a flat tax.

III. Western Europe: The American Challenge

The Angel Of Death. Europeans don't like Newt. Newt Gingrich is the Angel of Death of the Social Welfare State, not only in the US but also worldwide. If Americans succeed in shrinking both the welfare state and in reducing the role of government in the economy, then the competitive pressures on other industrial nations–especially in Western Europe–to do the same will intensify.

Of course, the European nanny states are far bigger relative to their economies than is the American version. Moreover, European beneficiaries of social welfare seem to be much less willing to accept reductions in their benefits than are Americans.

Resistance to change and social unrest may be the Europeans' initial response. But, they don't have much choice. The end of the Cold War dramatically increased the global competitive pressures on the industrial social welfare state from newly emerging countries with much lower labor, tax, and welfare cost structures.

In Europe, there is much less mobility than in the US. National loyalties and ties remain very strong. Within each European nation, ties to local communities often go back several generations. This is very unusual in the US.

In America, you can fire 10,000 workers. The only risk you have is that one of them will come back and blow you away with an AK rifle. The remaining 9,999 of them will either sign up for software programming courses at their local community college, or they'll rent a U-Haul hitch and move their families to wherever they can find a job. They won't demonstrate in the streets.

IV. France: They Just Don't Get It

U-Turn Or Dead-End? In France, the workers aren't as accommodating: They go to the streets to protest. When their jobs or wage gains are threatened, they've been known to shut down the airport in Paris or join a national strike.

French President Jacques Chirac in a televised interview on Thursday, October 26 announced that deficit reduction was now his top priority. This is quite a reversal from his campaign promises of quick job creation. When he was elected in May, one of the first acts of the government was to raise the minimum wage. The French unemployment rate has been hovering around 11.5% since April 1995. Raising the minimum wage simply increases the cost of labor and reduces the incentive to hire workers.

At Harvard Business School, Professor David Moss, co-author of our 1988 *New Wave Manifesto*, wrote a case study earlier this year on the problem of French unemployment. He calculated that the minimum wage in France is almost double the effective minimum wage in the United States.

Public approval of Mr. Chirac and Prime Minister Alain Juppe has hit a record low after less than six months in office. Now Mr. Chirac claims that fiscal austerity is "the priority of priorities." This U-turn could make him even less popular. The French may not be ready to accept austerity. For example, civil servants staged a nationwide general strike in October over a proposed wage freeze next year.

V. Germany: The Model Doesn’t Work

Too Rigid. While workers in France seem to walk out at the slightest provocation, Germans rarely strike.

> But the price for industrial peace is so high it has become untenable. Saddled with the world’s highest-paid employees and shortest working hours, Germany is feeling the heat from foreign competitors, particularly low-wage Eastern Europe. The bargaining system is being blamed for everything from high unemployment–currently 9.2%–to absenteeism double the US rate. (*The Wall Street Journal*, October 17, 1995.)

Germany’s collective bargaining system was created by the Allies after World War II. The centralized system provided for one set of negotiations to cover an entire industry by setting one wage scale. For decades, it worked well to promote labor peace and boost productivity. But it no longer works. It is too rigid and too slow to adapt to the new forces of global competition.

So is the tax system. Germany’s corporate tax rate is by far the highest of any OECD country. For average production workers, Germany has the fifth heaviest tax burden among all OECD countries. The top tax rate on income is 53%, well above the US top rate of 39.6%.

VI. Japan: Karaoke Capitalism

Keiretsu Capitalism. For all too long, Japan has been a rich country with poor consumers. The economic system has favored and enriched the producers while the standard of living of average Japanese consumers has stagnated and certainly declined relative to their counterparts in other industrialized nations.

Of course, there has been more job security in Japan than in other industrial economies. There is a greater respect for the well-being of others, less crime, and more social cohesion. But, surely all these highly desirable traits of Japan's society can be maintained while providing a better life for the average worker.

In the 1980s, many observers of Japan both there and overseas began to believe that Japan had created a new and more successful form of capitalism. In America, we feared that it might be superior to our competitive system. We didn't understand their "keiretsu" system of cross-ownership and cooperation very well. Still we were very impressed by the apparent successes of Keiretsu Capitalism.

Too Cozy. With the benefit of hindsight, I believe that what appeared to be a new form of capitalism has really been mostly old-fashioned corruption. My impression is that few if any business and economic relationships are conducted on an arm's-length basis. There is too much colluding, conspiring, and rigging occurring among the business elite, the government bureaucrats, and even the mob.

I prefer calling Japan's economic system "Karaoke Capitalism." The all-too-cozy cross-ownership relations among and between manufacturers, distributors, and the bankers worked well for all concerned when real estate values and stock prices were soaring and exports were strong. It must have been fun going to the karaoke bars to celebrate the boom during the 1980s.

Shortage Of Lawyers. But that was then, and this is now. Japan has only 0.3% of the world's landmass, yet it had 60% of the world's real estate value in 1989, by one estimate. It was the biggest speculative bubble of all times. It burst at the start of the decade.

The resulting bad loans created a horrendous banking crisis, which will be harder to fix than was the S&L debacle in the US. Ironically, Japan may not have enough lawyers! All of the bad deals of the 1980s in the US were based on very detailed legal contracts. When the deals fell apart, the same lawyers who wrote all the fine print were available to renegotiate and restructure the deals for their unhappy clients.

It is my impression that lawyers and contracts aren't as common in Japan. That was fine when all the deals worked so well for the Japanese in the 1980s. But now that the deals have blown apart, it may be very difficult to sort out who owns how much of the bad debts. This might explain why the Japanese still haven't set up an effective mechanism–like the Resolution Trust Corporation in the US–to unwind the bad loans.

The optimistic scenario for Japan is that they do set up such an institution soon. But the fix will initially cause even more deflation, which is what happened in the US during the S&L crisis of the late 1980s and early 1990s.

VII. Emerging Economies: Something Missing

The Greatest Emerging Market. In some ways, the emerging economies of today resemble the US economy when it was emerging during the 1800s. The US economy grew dramatically during that century. But there were lots of busts and panics along the way. There was plenty of corruption. Foreign investors lost huge sums of money on railroad deals that were either poorly conceived or just plain fraudulent. Long periods of inflation were followed by long periods of deflation. Despite all the turmoil and upheaval, the history of the US economy is the history of one of the greatest emerging economies of all times.

Two Key Ingredients. There were at least two very important ingredients behind America's success story. The country had a solid legal system and a relatively egalitarian distribution of income. Capitalism is first and foremost a legal system. It requires laws that protect property rights. It depends on the enforceability of contracts. The legal system has to be anchored in a body of precedent, but it must be flexible enough to adapt to the changing requirements of a dynamic economy. The rulings of the Supreme Court during most of the 1800s consistently favored the advocates of economic progress.

Many emerging markets today don't have legal systems that can accommodate the needs of a rapidly growing economy. Without this legal infrastructure, economic activities become less and less efficient. Without well-defined property rights and contracts, it becomes harder and harder to organize and execute the larger scale of transactions that are the milestones of growth. (In the Russian version of capitalism, entrepreneurs sell stolen goods in free markets.)

Another major deficiency of many emerging economies is their income distribution. Fast economic growth requires a certain level of social stability and consensus. If, during periods of rapid growth, the rich get richer while the poor are left behind and see no prospects for sharing in some minimal way in the new bounty, then rebels will emerge as they did last year in Mexico. Insurrection is very unsettling to foreign investors.

VIII. Conclusion

The more that overseas investment conditions appear unsettled to global investors, the more bullish it should be for stocks and bonds in the US, where the long-term outlook for financial assets continues to improve dramatically. The US economy has adapted best of all others to the challenges and opportunities of the New World Economic Order which followed the collapse of Soviet communism. Inevitably, the other industrial economies will follow America's lead in restructuring their economies to be more prosperous.