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**#31 Economic Consequences Of The Internet**

Topical Study #32

# THE UNDEFEATED FORCES OF DEFLATION

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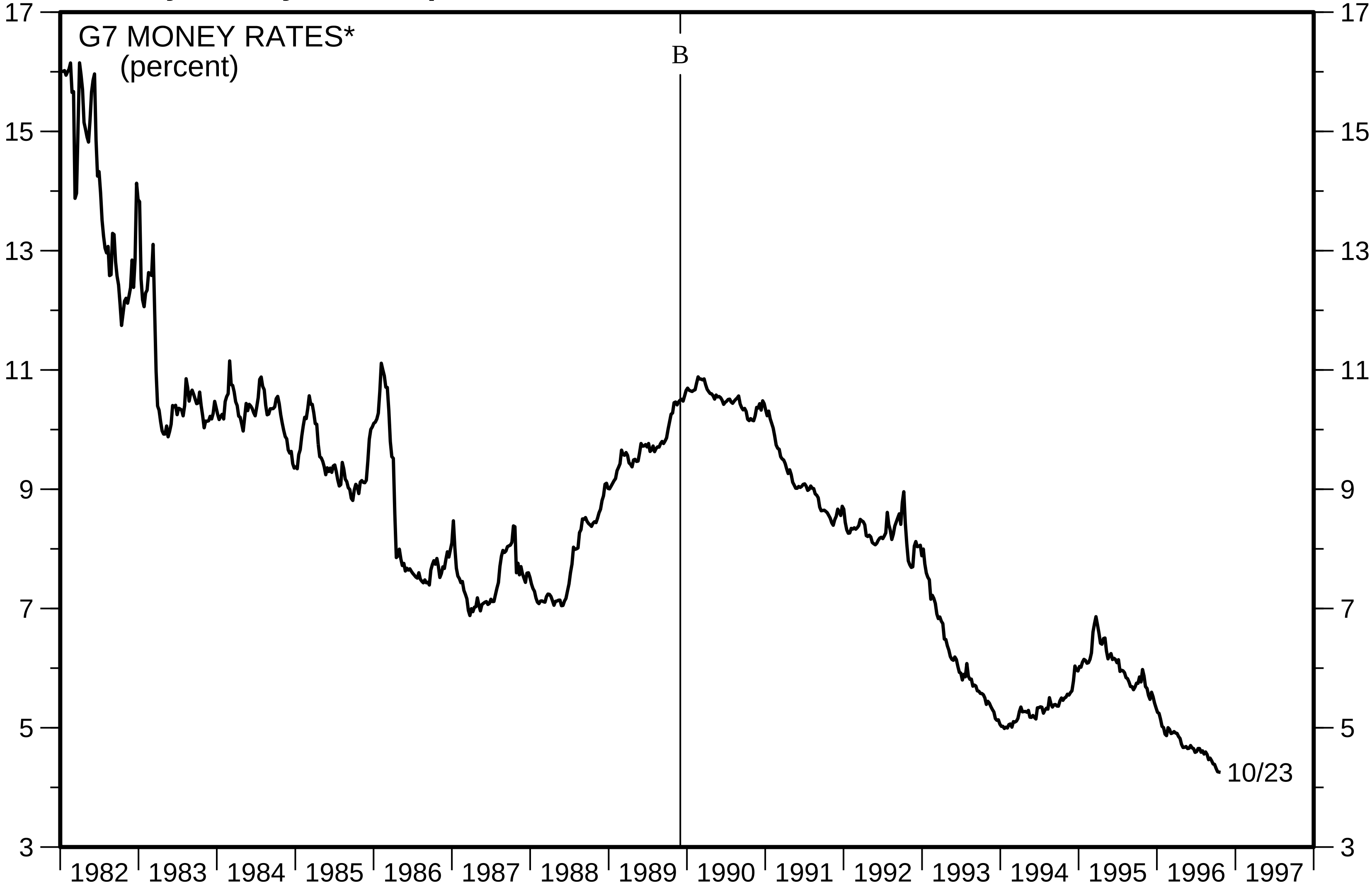
#1 Easy money offsets post-cold war forces of deflation.




* Unweighted average of US 3-month T-bill rate and 3-month Euro rates for Canada, UK, Germany, France, Italy and Japan.
B = Fall of Berlin Wall.

## I. Dis, De, Re

I believe that Deflation is a higher probability alternative scenario to Disinflation than is Reflation over the next 5 to 10 years. Here's my probability ranking:

| | |
|---|---|
| Disinflation (0% to 2% price increases): | 60% probability |
| Deflation (0% to 5% price *decreases*): | 25% probability |
| Reflation (inflation rises to 4% or higher): | 15% probability |

Previously, I've shown you that prices tend to soar during major wars and to plunge during the ensuing peace. This time has been different: Prices did not plunge after the end of the 50-Year Modern War, which includes World War II and the Cold War.

It has been different this time because the central bankers of the major industrial economies have provided very easy money. The unweighted average of three-month interest rates among the Group of Seven (G7) industrial nations is currently down to 4.3%, well below the 10.5% unweighted average during the week of November 15, 1989, when the Berlin Wall came tumbling down (Exhibit 1 on page 2).

Some of the G7 nations, specifically the English-speaking ones, have restructured their economies faster and adjusted better to the competitive economic forces unleashed by the end of the 50-Year Modern War. Those that have not done as well have the lowest interest rates because the forces of deflation are more intense for the laggards. Japan's three-month interest rate is only 0.5%. Germany's rate is down to 3.2% currently from 10% at the end of 1992 (Exhibits 2 and 3).

## II. Deflation: Defeated Or Delayed?

The big question for bond and stock investors today is whether the G7's monetary stimulus has defeated the forces of deflation or simply delayed the day of reckoning? I'm leaning toward delayed rather than defeated:

1) If I'm right, then the G7 central bankers will have to keep short-term interest rates very low, but eventually prices will fall anyway. For the next 1 to 5 years, or before the onset of deflation, this should be a bullish scenario for bonds and stocks. If and when prices of goods and services start to spiral downwards, bond yields would continue to fall, but so would stock prices.

2) If I'm wrong (i.e., deflation is no longer a risk at all), then the G7 central bankers may already have overstayed their welcome on the easy side of the monetary street. In this scenario, a global synchronized boom is likely in 1997 with at least a cyclical, and possibly a secular, rebound in inflation. The unweighted average of G7 short-term interest rates wouldn't remain at current levels and it certainly wouldn't fall. It would rise. This would be very bearish for bonds and stocks.

## III. Deflation: Up Close And Personal

To put it simply, it is my opinion that stimulative G7 monetary policies are countering deflation rather than reviving inflation. The G7 central bankers are offsetting the forces of deflation with easy money. Let's have a closer look at the forces of deflation. I see at least six coming at us right now:

**1) High-Tech Deflation.** In my previous Topical Study #31, dated October 22, 1996 and titled "*Economic Consequences Of The Internet*," I argued that the High-Tech Revolution has deflationary consequences. The prices of the outputs of this sector are always falling, even as the hardware and software become more powerful. These products are also the inputs of many industries. As these input prices fall, competition puts downward pressure on other prices. The Internet has a very deflationary potential because consumers can find the lowest prices for more and more goods and services anywhere on the planet at a search cost near zero.

**2) China Syndrome.** The world's two largest construction projects are currently in China. The biggest is a huge dam and industrial complex in Hunan Province. The second-biggest is the new airport development in Hong Kong. The airport will serve as industrial China's major shipping port to the world of very competitively priced products.

China is rapidly emerging as a fierce competitor in global trade. Over the past 12 months through August, the US trade deficit with mainland China rose to $36 billion versus $10 billion during 1990 (Exhibits 4 and 5).

**3) Easy Equity Money.** Low interest rates in the G7 economies have been very bullish for stocks, not only in the US, but also in many other bourses around the world (Exhibits 6 and 7). The cost of equity capital is very low. Hong Kong's huge airport development is just one of numerous examples around the world of the enormous sums of money available for good projects.

Cross-border direct investing is soaring. For example, the sum of US direct investments overseas and foreign direct investments in the US hit a record $188 billion over the past four quarters through mid-1996 (Exhibit 8). In the US, merger and acquisition activity and initial public stock offerings have also been at records recently (Exhibit 9).

All this financing activity is rapidly increasing global capacity in many important industries. Overexpansion is conceivable, which would be deflationary, of course.

**4) The Bubble.** Besides fueling capacity overexpansion, financial markets could be the source of deflation in another way. Greed could completely overwhelm fear, sending stock prices to the moon and beyond. There are already $1,250 billion in equity mutual funds in the US, up from $251 billion at the end of 1989 (Exhibits 10 and 11).

Stock prices might not get beyond the moon if Fed Chairman Greenspan decides to raise interest rates to stop the speculative orgy. If he is forced to do so when the economy is already weak, a recession could result as stock prices crash back toward the planet Earth. In this scenario, deflation is a possible outcome.

**5) European Monetary Unification.** The Maastricht requirements for European monetary unification are forcing the would-be union members to reduce their fiscal deficits and spending. The unweighted average of the yearly percent change in real government spending in Germany, France, Italy, and the UK is down to 1.4% from 3.5% during the first quarter of 1992 (Exhibit 12). This has certainly contributed to the high unemployment rate in Europe (Exhibit 13).

The unemployment rate would probably decline if European labor markets weren't so rigid. But old habits are hard to break. Expensive social and corporate welfare programs designed to cushion workers from economic adversity must be dismantled to lower labor costs and create new job opportunities for the unemployed. Unfortunately, there is much resistance to such change. If there is no change, the European economies will remain depressed and contribute to the global forces of deflation. If rapid restructuring does take place, deflation would probably still occur during the transition to more competitive European economies.

**6) Japan's Depression.** The big 12.2% jump in Japan's real GDP during the first quarter suggests that the worst is over for Japan's economy. Probably so, but maybe not. Japanese companies adjusted well to the end of the Cold War by moving more of their production to several emerging Asian countries, where labor costs are low. The Japanese didn't shut down plants at home at the same time. So there is still plenty of excess capacity and "hidden" unemployment in Japan. In other words, the Japanese economy still requires a great deal of restructuring.

## IV. War And Peace

The history of the United States shows that the periods of inflation coincided with wars and deflations with the subsequent peace (Exhibit 14):

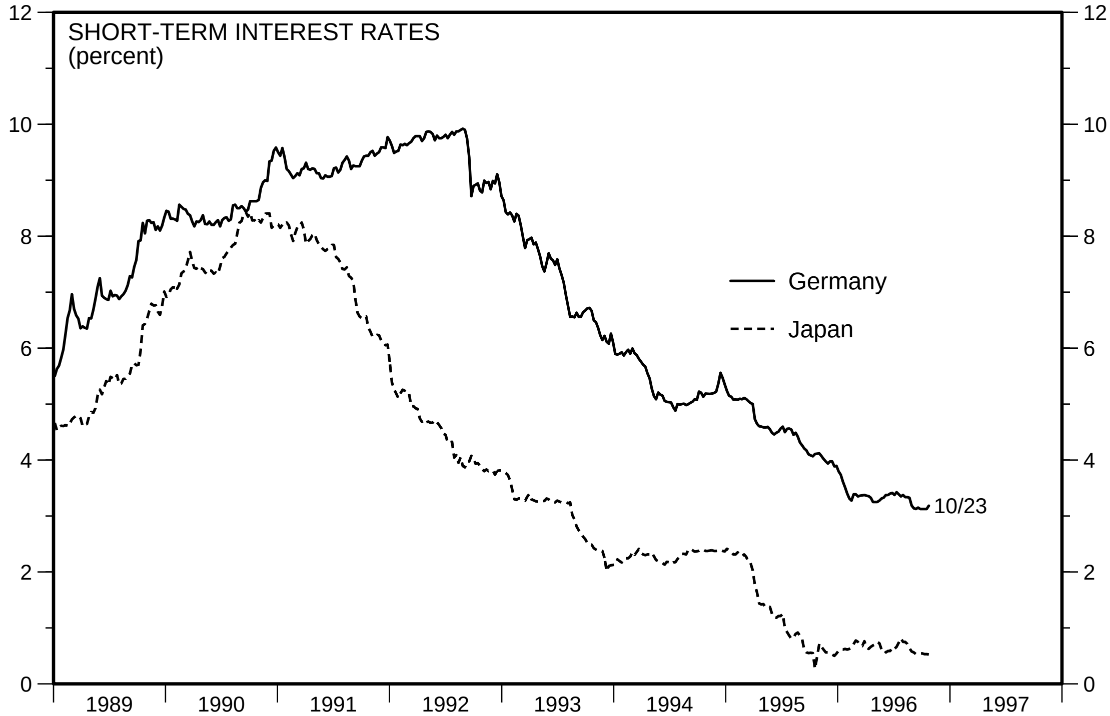
1) During the War of 1812, the CPI rose 47%. It fell 48% after the war.
2) During the Civil War, the CPI rose 81%. It fell 40% after the war.
3) During World War I, the CPI rose 140%. It fell 35% after the war.

During World War II through the end of the Cold War, the CPI soared 488% (Exhibit 15). So far, prices have not fallen. They still might. We'll see.

# - G7 Interest Rates -

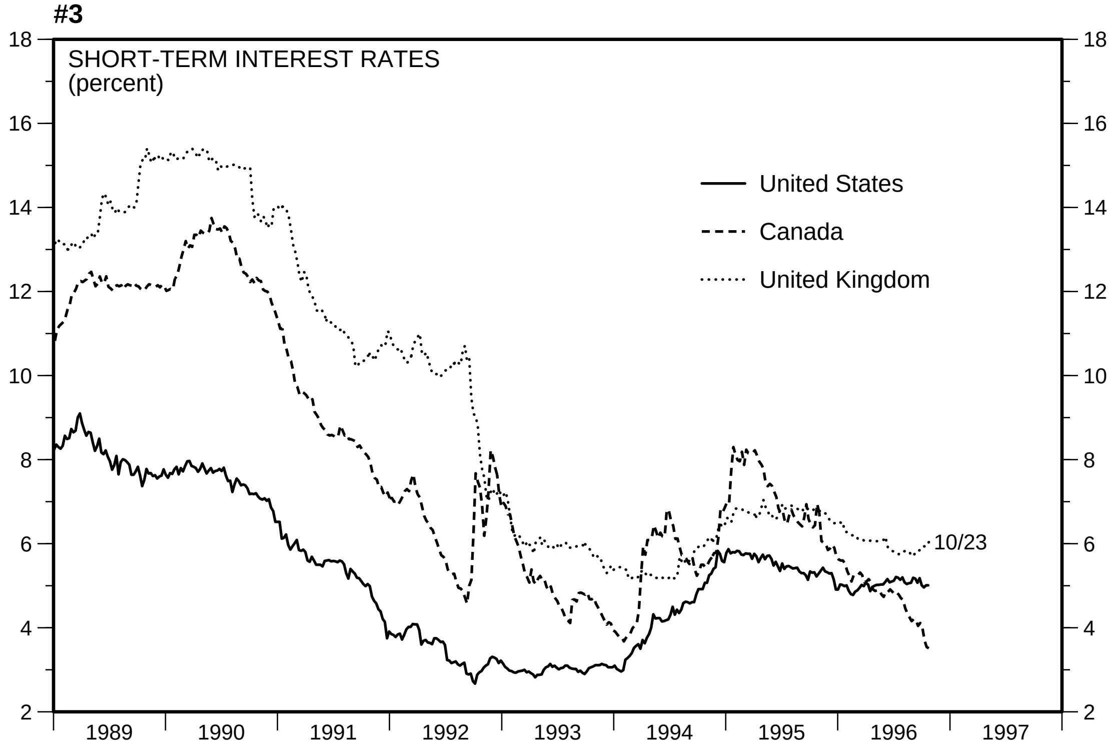
Despite huge drop in short-term interest rates, economies of both Germany and Japan remain weak. Neither has adjusted well to post-cold war pressures.

#2




English-speaking industrial economies have adjusted better to post-cold war economic shocks so interest rates are higher than in Germany and Japan.

#3



# - China Trade -

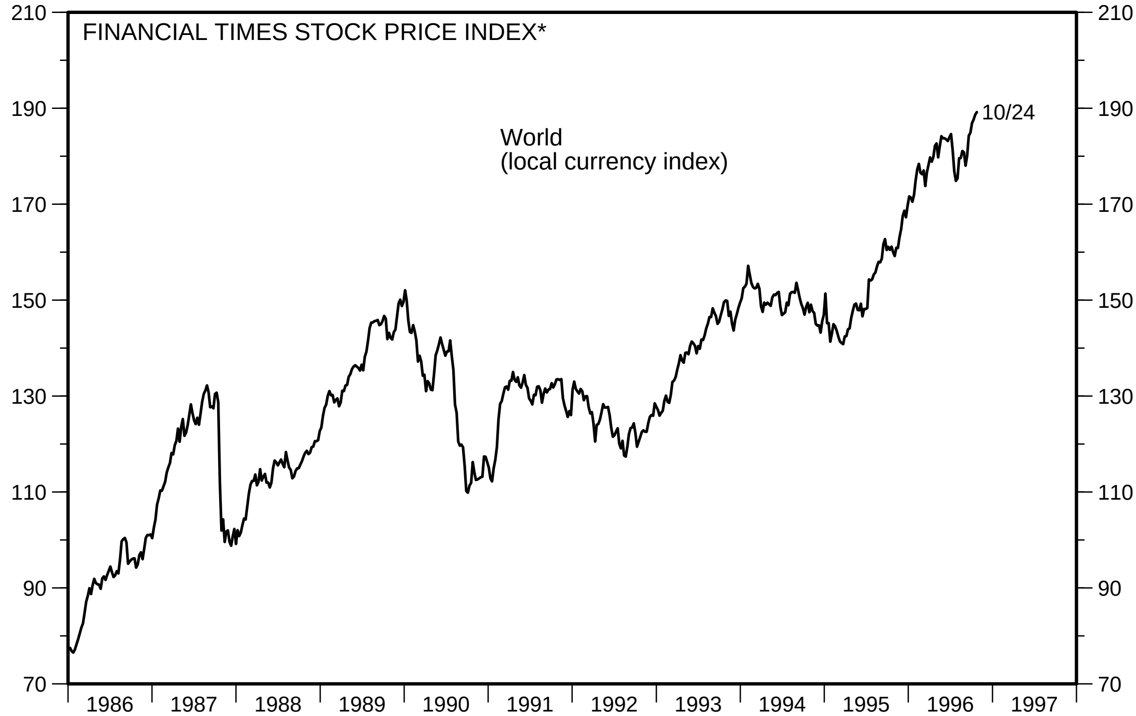
#4


US trade deficit with China is soaring.

#5

# - World Stock Prices -

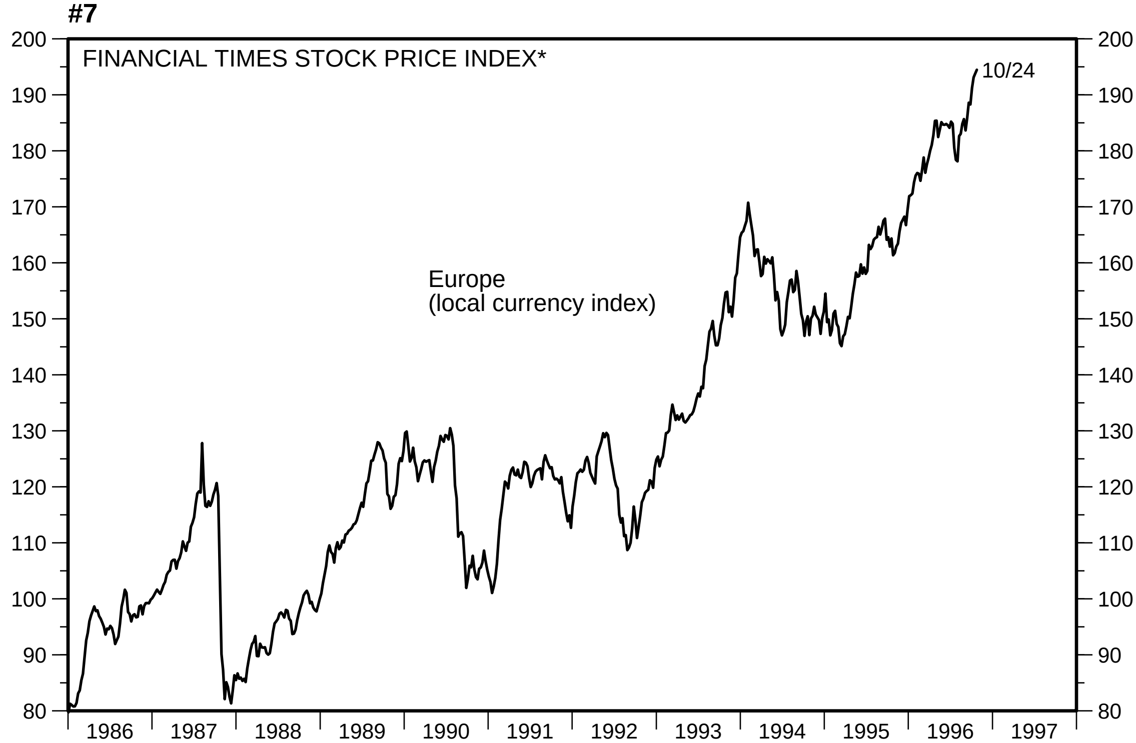
#6




* Includes Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Italy, Japan, Malaysia, Mexico, Netherlands, New Zealand, Norway, Singapore, South Africa, Spain, Sweden, Switzerland, United States, and United Kingdom.

Easy money in G7 economies is pushing stock prices to record highs.

#7

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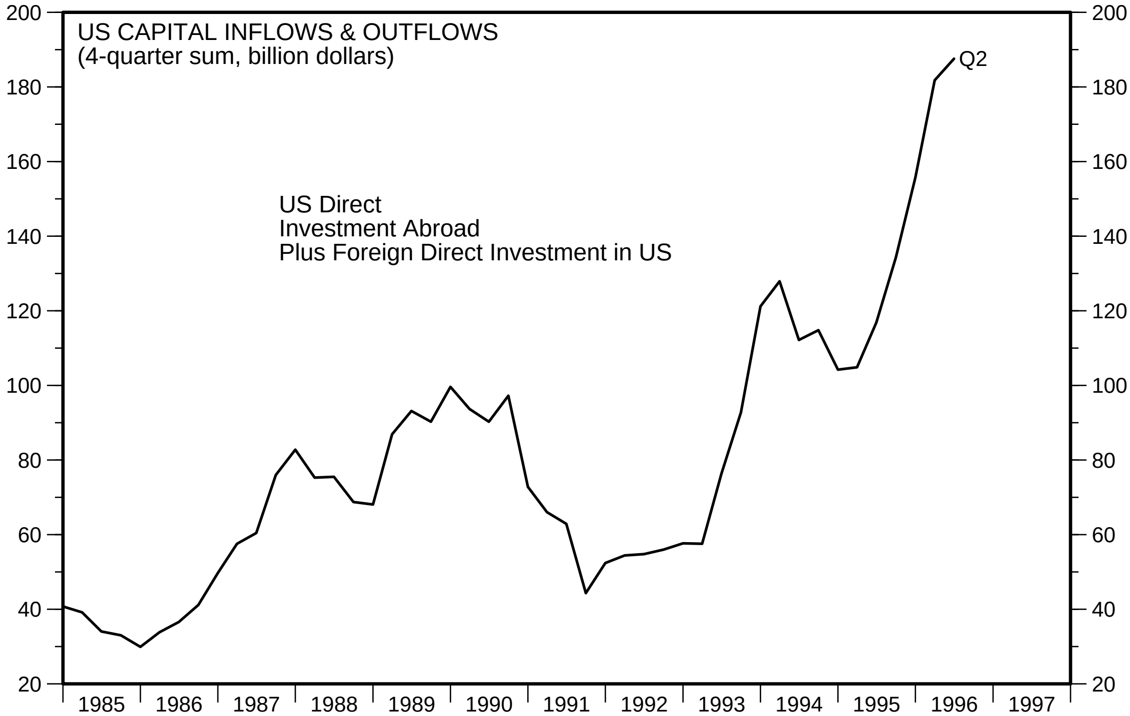
# - Corporate Finance -

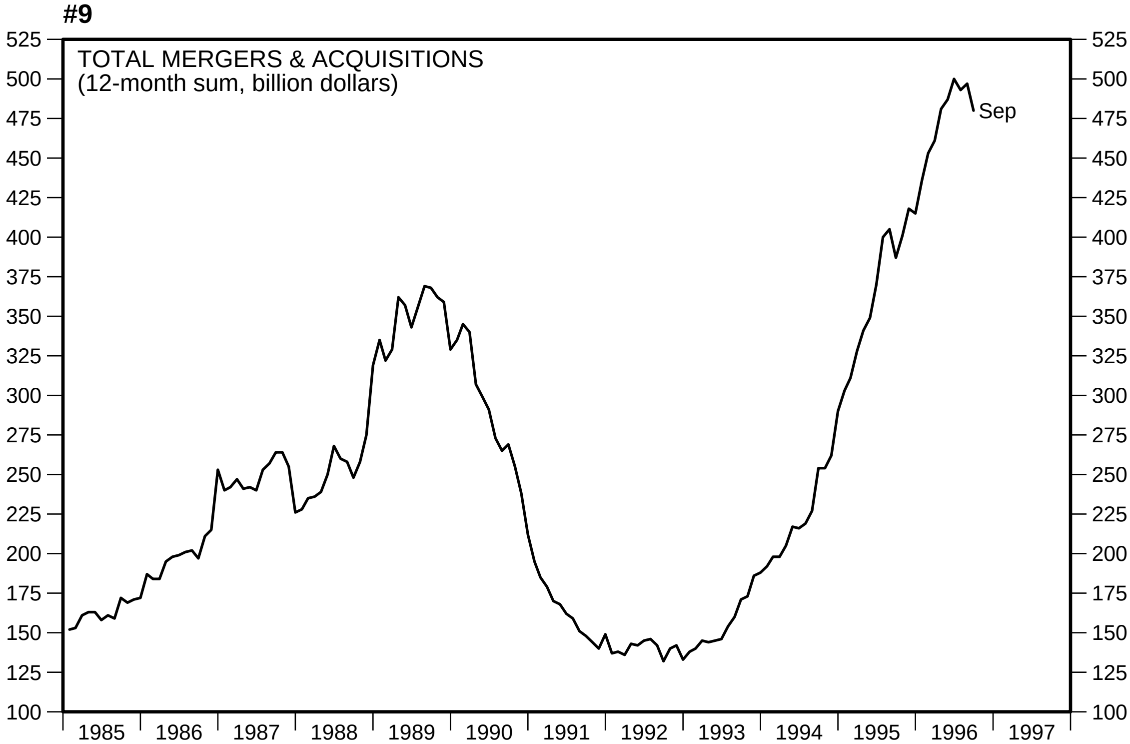
**#8**




Source: Federal Reserve Board, Flow of Funds.

US "in-and-out" cross-border direct investments are at a record of nearly $200 billion.

**#9**



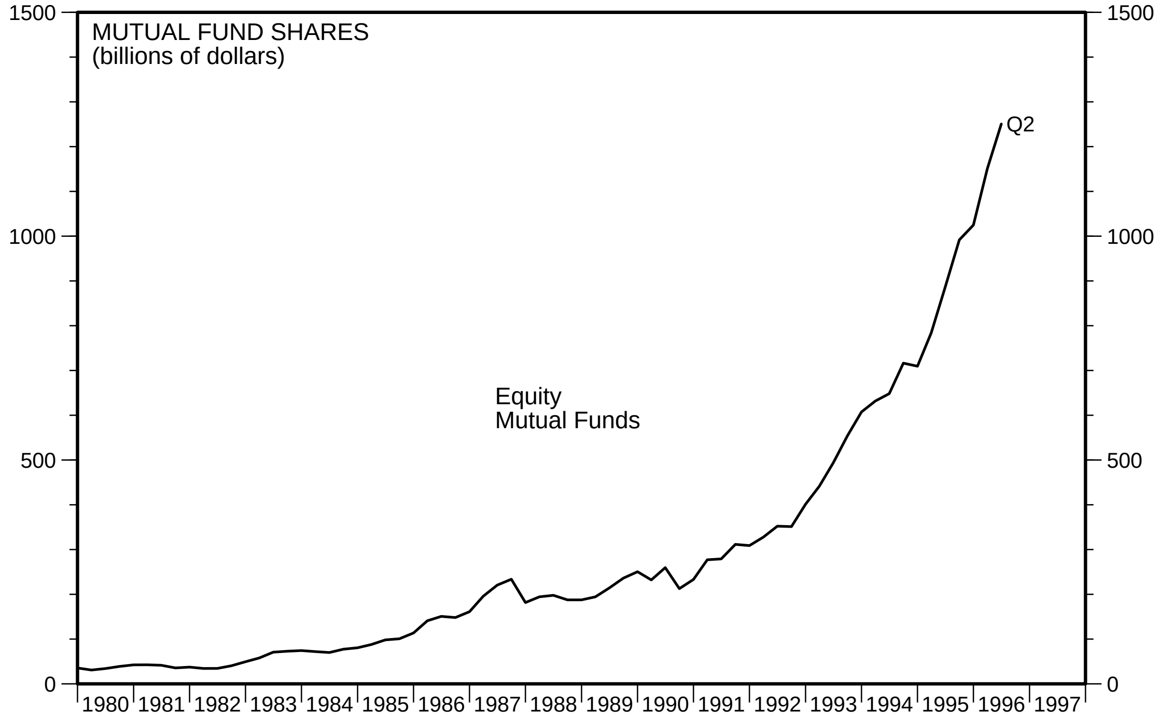

Source: Securities Data Corp.

M&A activity is at an all-time high of about half a trillion dollars over the past year.

# - Equity Mutual Funds -

Since the end of 1989, the value of equity mutual funds is up 398%. Stock prices are up 91% over this period. Since the end of 1989, these funds are up $1 trillion with net inflows of $653 billion and capital gains of $347 billion.

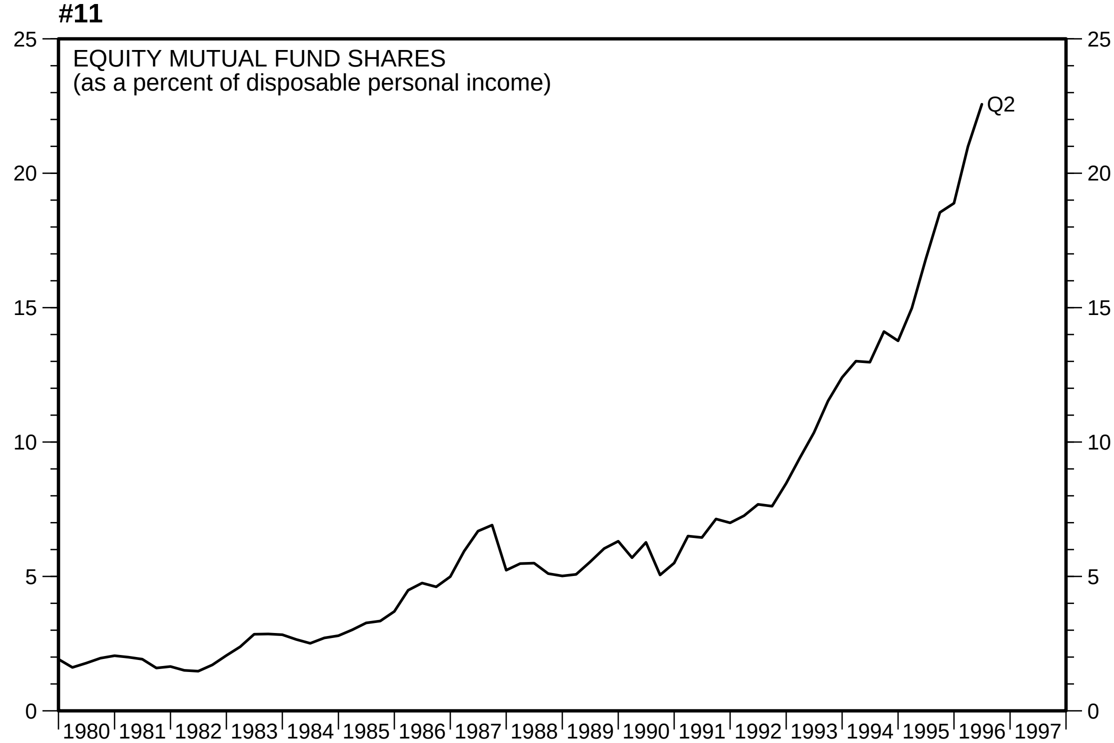
**#10**




Source: Federal Reserve Board, Flow of Funds Accounts.

Equity mutual funds are nearly one-quarter as large as personal disposable income.

**#11**




Source: Federal Reserve Board, Flow of Funds Accounts.

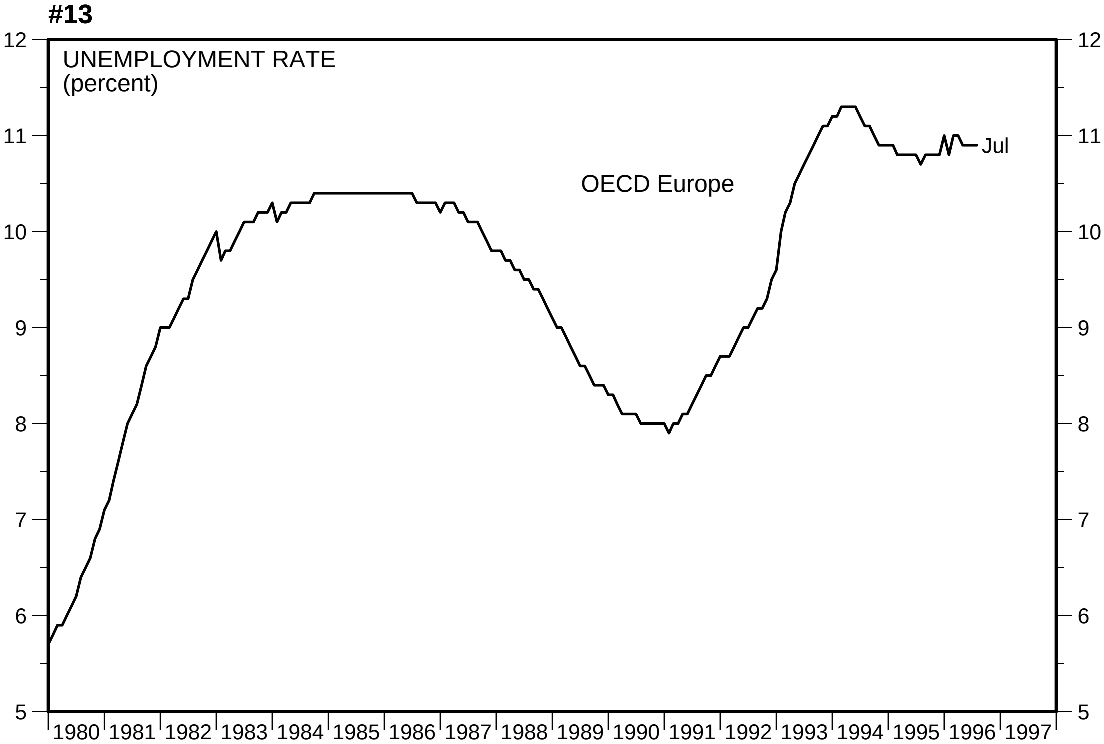
# - Europe -

#12


* Unweighted average of Unified Germany (West Germany prior to 1992), United Kingdom, France and Italy.

Fiscal drag in Europe is one of the reasons that unemployment exceeds 10%.

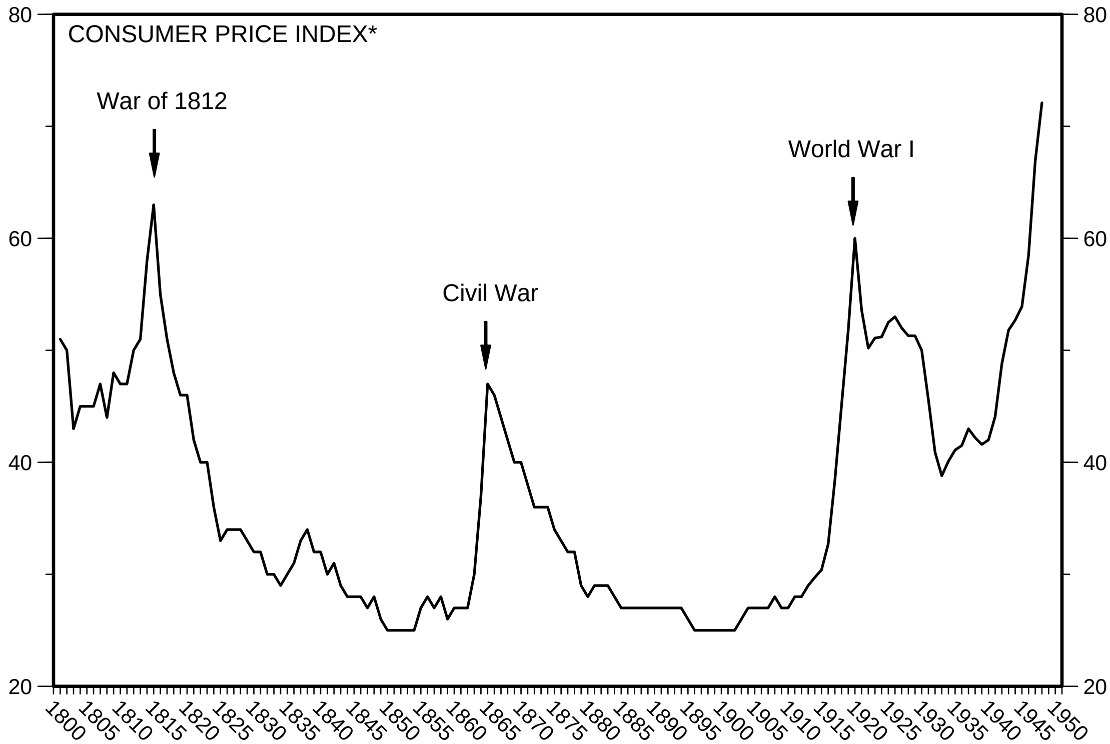
#13



# - War & Peace -

Prices soar during wars, collapse during peace times.

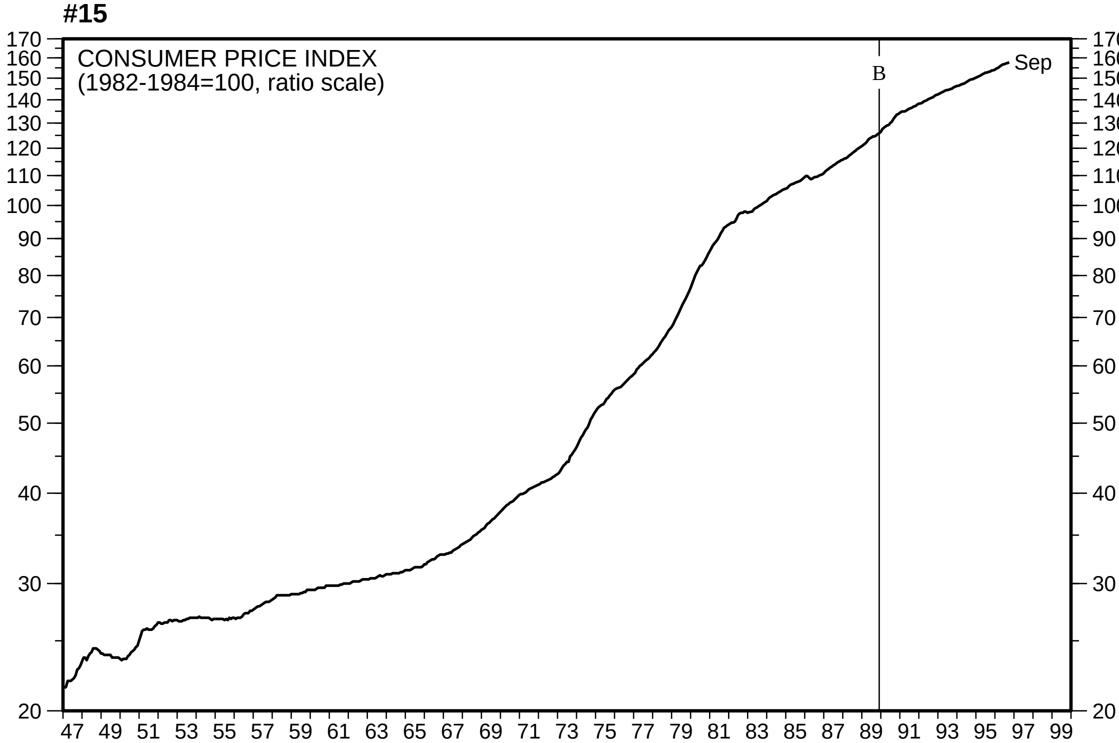
#14




* Base index from 1800 to 1947 is 1967 = 100.

So far, the end of the 50-Year Modern War hasn't been deflationary.

#15




B = Fall of Berlin Wall.