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Topical Study #43

THE ECONOMIC CONSEQUENCES OF THE PEACE: IN 1999 & BEYOND

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I. Introduction

The end of the Cold War in 1989 was undoubtedly one of the most important events in world history.[1] The monumental political importance of the end of the superpowers' military and ideological rivalry was obvious and immediately recognized by everyone transfixed by the television coverage of the populist demolition of the Berlin Wall during November 1989. The end of the Cold War marked the beginning of a New Era, not only for international political relations, but also for the global economy. Ten years later, there is still more agreement than disagreement about the political consequences of the end of the Cold War. Yet, even today in 1999, the ***economic*** consequences of the end of the Cold War are either not fully recognized, or are hotly debated:

Deflation. History shows that peace times are usually periods of deflation, i.e., falling prices. Since the start of the 1990s, inflation rates in the major industrial economies have declined significantly, and are near zero as the decade ends. Yet, most economists continue to believe that history will not be repeated because central banks will avert deflation with reflationary monetary policies. Easy money should eliminate excess supply—the cause of deflation—by boosting demand, thus closing the gap with supply.

I think they are wrong. The forces of deflation have not been defeated, and they are likely to prevail over the next few years.[2] Perversely, easier credit might prop up supply more than boost demand. In the long run, the most effective way to eliminate excess supply is to allow market forces to put insolvent producers out of business. In the short run, of course, this is the most painful path, and often triggers political intervention, that worsens the long-term deflation problem.

Globalization. "Globalization" and "restructuring" have become part of the vocabulary of the New Era. The definitions are vague, and may explain why there is so much controversy about whether these are good or bad trends. Protectionists decry the economic and financial turmoil caused by globalization and restructuring. In their opinion, the Asian Contagion and the Long-Term Capital Management crisis are recent examples of the downside of global capitalism. They advocate government protection from these "cruel and unfair" market forces, and more government regulation of "crony capitalism."[3]

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[1] This study is an update of my Topical Study #35, "The Economic Consequences Of The Peace," May 7, 1997. I first started to forecast the economic and financial consequences of the end of the Cold War in Topical Study #17, "The Triumph Of Capitalism," Aug. 1, 1989.
[2] See my Topical Study #32, "The Undefeated Forces Of Deflation," Oct. 28, 1996.
[3] In the progressive/populist tradition, William Greider critiques globalization in *One World, Ready Or Not: The Manic Logic of Global Capitalism*, Simon & Schuster, 1997. See also Robert Samuelson, "Global Capitalism, R.I.P.?" *Newsweek*, Sep. 14, 1998. His main point is that "much of the world simply doesn't have the values needed for free markets."

I am for regulated free-market capitalism. I hope this will be the choice of Asians, Russians, Latins, and other peoples who have experienced recent reversals of fortune. Whether we like it or not, markets always become more global during peace times, forcing companies to restructure the way they were doing business during the preceding war times. We can resist these changes, or else we can adapt, and learn to prosper in competitive markets. Recent problems in Asia were not caused by unregulated crony capitalism, but rather by crony corruption. Capitalism may have defeated Communism, but it has yet to completely triumph over another adversarial economic system, namely, Corruption. Capitalism is, first and foremost, a legal system that protects property rights and enforces contracts. I advocate government regulation (not protection)—especially in banking and securities markets—to eliminate corrupt practices, thus fostering a legal climate that is conducive to capitalism.

New Economy. In the United States, during the second half of the 1990s, economists debated whether the business cycle was still relevant in the New Era. The so-called "New Paradigm" or "New Economy" camp argued that inflation could remain low even if strong economic growth continued to push the unemployment rate to the lowest level in decades. The High-Tech Revolution is just one of several new developments that have weakened the traditional trade-off between unemployment and price inflation. The counter-revolutionaries sought to debunk the New Era, and to defend the old order: Strong growth would lead to inflation. Higher inflation would force the Federal Reserve to boost interest rates. Tight credit would then cause a recession. The old-era business cycle is alive and well.

I believe that the Traditional Business Cycle model is no longer relevant. However, I am not promoting a new paradigm. Rather, I believe that a very old paradigm, i.e., Perfect Competition, has never been more relevant. If so, then inflation is probably dead, and a "Fed-led" recession is, therefore, very unlikely. But recessions can occur in the New Era. For the first 10 years, the New Era was a Golden Era for much of the global economy, especially in the US. New eras are rarely golden all the time. Bad things can happen even in new eras.[4]

Yahoo Economy. Contributing to the sense that we are in a Golden Era is the High-Tech Revolution. In the stock market, the technology sector has been the strongest of the 11

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[4] I was the first proponent of the New Era view in Topical Study #15, "The New Wave Manifesto," Oct. 5, 1988, and Topical Study #25, "The High-Tech Revolution In The US of @," Mar. 20, 1995. *Business Week* coined the phrase, "New Economy." See Michael J. Mandel, "The Triumph of the New Economy," *Business Week*, Dec. 12, 1996, and "New Thinking About The New Economy," May 19, 1997. See also Stephen B. Shepard, "The New Economy: What It Really Means," *Business Week*, Nov. 17, 1997. "New Paradigm" was the paper tiger invented by Stephen Roach, the Chief Economist of Morgan Stanley and the leading defender of the Old Order on Wall Street. In academia, Professor Paul Krugman of MIT (www.mit.edu/krugman/www/) is the leading counter-revolutionary.

sectors of the S&P 500 composite of companies since 1993. More recently, Internet stocks have soared beyond any traditional relationship with actual and prospective earnings. Some argue that the New Economy is morphing into the "Yahoo Economy." Technology has the potential to create extraordinary prosperity for everyone around the world.

I am sympathetic to this happy notion. But there are some clouds that come with the silver lining. In the short term, there is the Year 2000 Problem (Y2K) with our computers. Undoubtedly, most will be fixed in time to recognize that "00" is actually the year 2000, not 1900. But, it is very likely that some serious glitches will occur, and that they could be very disruptive to business and government for several months, at least. In the long run, Internet is not good for everyone. It is bad for intermediaries between producers and consumers. In many ways, it is fundamentally deflationary.[5]

Over the past 10 years, I have promoted the notion that the end of the Cold War—the triumph of Capitalism over Communism—was wildly bullish for stocks.[6] I argued that it would lead to lower interest rates and inflation rates around the world. I was one of the first to predict that the aging of the Baby Boomers would be very bullish for stocks.[7] I was an early proponent of the bullish implications of the High Tech Revolution. I have been one of the strongest advocates of the New Economy view claiming that a secular rebound in productivity would allow both strong growth and low inflation. I still believe in all these secular trends. <u>That is why I still expect to see the Dow Jones Industrial Average at 15,000 by 2005.</u> But, before then, I expect we will see a 30% drop over the next 12-18 months. My three main concerns are the same ones I discussed during the summer of 1997, namely, irrational exuberance, deflation, and Y2K.[8]

II. War & Peace & Prices

The collapse of the Berlin Wall marked the end of the 50-Year Modern Day War—which includes World War II, the Cold War, and numerous regional wars from Korea to Vietnam to Central America to Southern Africa and several other hot spots around the world. This war, which lasted half a century, was in its effect an unprecedented trade barrier. Americans were prohibited from trading with Communist countries. The Iron Curtain was a major obstacle to trade between all countries on opposite sides of the curtain. The lifting of the curtain, the destruction of the Berlin Wall, the collapse of Soviet imperial communism all simultaneously heralded the elimination of the world's greatest barrier to trade. Coincidentally, trade among "Free World" countries was liberalized

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[5] Topical Study #31, "Economic Consequences Of The Internet," Oct. 22, 1996.
[6] Topical Study #18, "Dow 5000," May 9, 1990, Topical Study #20, "The Collapse Of Communism Is Bullish," Sep. 4, 1991, and Topical Study #23, "The End Of The Cold War Is Bullish," Sep. 10, 1993.
[7] Topical Study #12, "How The Baby Boomers Are Changing The Economy," Apr. 6, 1988.
[8] Topical Study #37, "NEW ERA RECESSION? Deflation, Irrational Exuberance, & Y2K," Jul. 14, 1997.

further by 1) the Europe 1992 movement, 2) the Uruguay Round of trade talks under GATT completed during 1993, and 3) the North American Free Trade Agreement of 1994. China remains in communist hands, but trade between China and the rest of the world, especially the United States has expanded significantly in the 1990s.

There has been a dramatic expansion of global trade, capital flows, and direct investment since 1989:

1) According to data compiled by the International Monetary Fund, total world exports at an annual rate rose to $5.6 trillion during the first half of 1998, up 86% since 1989.

2) Cross-border loans of international banks soared 98% from $4.6 trillion during the second quarter of 1989 to $9.1 trillion in mid-1998, according to the Bank for International Settlements.

3) International banks increased their loans to Asia, (excluding Japan, Hong Kong, and Singapore) by 251%, from $137 billion to $481 billion, between the second quarter of 1989 and the second quarter of 1997, just before the start of the Asian Crisis. Other lenders and investors poured money into Asia and other emerging economic regions with equal enthusiasm, expecting that the New Era would produce golden returns. (In many ways, the "Asian Miracle" of the 1990s can be easily explained as an investment bubble, with too much money chasing too few good deals.)

4) The sum of US direct investment abroad and foreign direct investment in the US swelled from $94 billion at the start of the decade to a record $224 billion in 1998, according to Flow of Funds data compiled by the Federal Reserve. US direct investment abroad hovered between $10 billion and $30 billion per year during the 1980s, then soared to a record $130 billion in 1998.

All wars are trade barriers. They divide the world into camps of allies and enemies. They create geographic obstacles to trade, as well as military ones. They stifle competition. Economists mostly agree that the fewer restrictions on trade and the bigger the market, the lower the prices paid by consumers and the better the quality of the goods and services offered by producers. These beneficial results occur thanks to the powerful forces unleashed by competition. Peace times tend to be deflationary because freer trade in an expanding global marketplace increases competition among producers. Domestic producers are no longer protected by wartime restrictions on both domestic and foreign competitors. There are fewer geographic limits to trade, and no serious military dangers. As more consumers become accessible around the world, more producers around the world seek them out by offering them competitively priced goods and services that offer high-quality standards compared to the competition. Entrepreneurs have a greater incentive to research and develop new technologies in big markets than in small. Big markets permit a greater division of labor and more specialization, which is also conducive to technological innovation.

History shows that prices tend to rise rapidly during war times and then to fall during peace times. War is inflationary; peace is deflationary. In the United States, for example:

- During the War of 1812, the CPI rose 47%. It fell 48% after the war.
- During the Civil War, the CPI rose 81%. It fell 40% after the war.
- During World War I, the CPI rose 140%. It fell 35% after the war.
- From 1939 through 1947, during World War II and the start of the Cold War, the CPI rose about 50%.
- Then prices soared about 500% during the Cold War from 1947 to 1989.

During peace times, prices fell sharply for many years following all the wars listed above, except for the peace so far in the 1990s. Prices are still rising in the United States and in Europe, though at a significantly slower pace than during the previous two decades, when the Cold War was most intense. Japan is the one major industrial economy experiencing some deflation. If peace has been deflationary in the past, then why are prices still rising in the 1990s, albeit at a subdued pace? Is deflation still possible as we enter the next century? If peace prevails into the next millennium, will deflation prevail? Or is history mostly irrelevant, so inflation will persist and even rebound?

The "war and peace" model of inflation is simple and seems to account for the major price waves of the past. However, monetarists have plausibly argued that monetary policy and central bankers are also important contributors to the inflation process. I think some monetarists overstate their case when they claim that inflation is always a monetary phenomenon. *I believe that the competitive structure of markets is also a very important variable in understanding inflation.* But I also believe that money matters.

So far, in the peace of the 1990s, easy money has succeeded in offsetting the natural, peace-time forces of deflation. In the present situation, the central banks of the major industrial economies have eased credit conditions significantly in an effort to offset the forces of deflation. Of course, central bankers existed in the past when deflation prevailed, but monetary theory and operating procedures were primitive.

Gauging whether monetary policy is restrictive or stimulative can be very controversial. Orthodox monetarists focus on the growth of the money supply. More eclectic observers might prefer inflation-adjusted interest rates, i.e., real interest rates. I'm content to look at the unweighted average of three-month Euro deposit rates to gauge the direction of monetary policy in the Group of Seven (G7) countries. My approach is admittedly unscientific and casual, but the conclusion is obvious and robust: The G7 central bankers have lowered interest rates sharply to avoid deflation. The G7 short-term rate plunged from about 10% on November 1989, when the Berlin Wall was dismantled, to 3.7% at the end of 1998. Nevertheless, inflation rates have continued to fall and are now very close to zero, i.e., literally on the edge of deflation. Why? Is deflation inevitable?

III. The End Of Macroeconomics

Have the central bankers defeated or just delayed the forces of deflation? This is one of the big questions for economic forecasters looking into the next century. If the risk of deflation is minimal, then the downtrend in interest rates during the 1990s may be over, and could possibly be reversed by the start of the new century. In this case, the major economic legacy of the end of the Cold War was short-lived and much less significant than I believed it would be. Time will tell, of course. My hypothesis is that the forces of deflation have not been defeated, and they will soon prevail.

Francis Fukuyama wrote a controversial article in the Summer 1989 issue of *The National Interest* titled, "The End of History?" He argued that the ideological battle between capitalism and communism was over. The clear winner was capitalism. The clear loser was communism. To the extent that history consists mostly of epic struggles between opposing forces, the triumph of capitalism also marked the end of history. In the same spirit, I would like to propose a simple notion: Macroeconomics is dead. The triumph of capitalism also marked the triumph of ***micro***economics over ***macro***economics. This is an unfortunate division in the economics profession. As a result, macroeconomists often fail to understand the impact of changes in market structure and industrial organization on the overall economy. They tend to promote an elitist (Keynesian) notion that they can fine-tune the economy from on high, while the little people go about their daily business.

My major premise is that our economic present is better understood, and our economic future is more accurately predicted, by a model from the microeconomics textbooks than from the macroeconomics textbooks. The new "in" model is Perfect Competition. Out are Keynesian, monetarist, and other macro models. The perfectly competitive marketplace has the following characteristics:

1) The goal of firms is to maximize their profits.
2) There are no barriers to entry for new firms.
3) The factors of production are mobile.
4) The number of competing firms can be as numerous as the market can profitably sustain.
5) There is no protection from failure. There are no government support programs or self-perpetuating monopolies, oligopolies, or cartels.
6) The goal of consumers is to maximize their utility given their budget constraints.
7) Consumers are free to purchase the best products at the lowest price from any producer. They have cheap and readily available information available to them to make their choices.

This model of perfect competition predicts that the market price will be equal to the marginal cost of production. No one firm, or group of firms, can set the price. Profits are minimized to the lowest level that provides just enough incentive for a sufficient number of suppliers to stay in business to satisfy demand at the going market price. Consumer

welfare is maximized. This simple model is fairly static and needs to be combined with models of economic growth. It also needs to be more dynamic to reflect the impact of technological innovation. Despite these limitations, this textbook model of perfect competition has probably never been more relevant than it is today:

1) In capitalist societies, the pressure to maximize shareholder value is intense. Company managers are taking big risks to restructure their businesses with the goal of increasing profitability. In formerly communist countries and in newly emerging ones, governments are privatizing state-owned enterprises and permitting foreign ownership.

2) Globally, there are fewer barriers to entry as a consequence of the end of the Cold War. This is certainly true geographically. It is also true in other ways. For example, a potential barrier to entry in some industries is the availability of financing. Technology is especially dependent on venture capital. Low interest rates and booming stock markets around the world during most of the 1990s provided plenty of cheap capital—too much in some cases.

3) Factors of production are becoming more mobile because companies are becoming more mobile. US corporations have a long tradition of setting up operations overseas in local markets. Indeed, this accounts for the US trade deficit, especially with countries like Japan and Germany that until recently had a more mercantilist business tradition of exporting to their foreign customers. But change is occurring. Japanese and German companies are globalizing their operations.

4) Foreign business ventures are attracted to emerging economies because government regulations are minimal and labor costs are very low. This trend is putting pressure on the governments of industrialized nations to deregulate their economies and to meddle less in disputes between workers and their employers.

5) Consumers and businesses are rapidly taking advantage of the Internet to obtain, at virtually no cost, the information they need to find the lowest prices for just about any product or service they desire.

6) Global firms are adopting price-cutting as a new competitive business strategy. They are striving to cut costs and to boost productivity in an effort to be among the lowest cost producers in the world. Profit margins evaporate quickly in competitive markets, so companies are under enormous pressure to innovate at a faster and faster pace. The simple goal is to sell as many units to as many consumers worldwide as possible at the lowest possible price in the shortest time period.

If perfect competition is the "new" model that best explains aggregate economic activity, then inflation may be dead too. If inflation is dead, then the Traditional Business Cycle may also be dead. In the New Era, companies are under enormous pressure to reduce their marginal costs so that they can offer the lowest prices. In this scenario, deflation is more

likely than reflation. If inflation remains low, central bankers won't need to tighten monetary policy in an effort to stop a cyclical rebound in inflation. Inflationary booms are less likely. Policy-engineered recessions are less likely as well.

Of course, not all recessions are policy-engineered. For example, a recession caused by the Y2K problem is very likely, in my opinion. However, the standard tools of macroeconomic analysis, particularly business cycle indicators, may no longer accurately reflect the true nature of our economy. Similarly, forecasts based solely on the business cycle model may also miss the mark. Furthermore, the secular trends unleashed by the High-Tech Revolution could overwhelm the cyclical pattern of the low-tech economy. Again, this is not to say that the business cycle is dead. However, it may no longer dominate the course of economic growth as it did in the past.

IV. Deflation & Corruption

In a perfectly competitive market, producers and consumers are "price takers." No one has enough clout in the market to dictate the price that everyone must receive or pay. The price is set by the "invisible auctioneer," who equates total market demand to total supply at the market's equilibrium price. Clearly, there can't be excessive returns to producers in a competitive market. If there are, they will be eliminated as new firms are attracted to enter the excessively profitable market. Firms that try to increase their profits by raising prices will simply attract more suppliers, or else lose market share to firms that hold the market price.

While the model predicts that no firm can set the market price, the reality is that any firm can lower the price. It will do so if management can find ways to lower costs and increase productivity. If it lowers the prices of its output below the market price, it will increase its unit sales and market share. This will be very profitable as long as unit sales increase more than prices are reduced. The problem is that competitors are bound to follow the path of the market leader. However, everyone can still profit as long as consumers respond to the industry's price cuts by buying more units. This is the ***Good Deflation*** scenario. Everyone benefits. Consumers enjoy lower prices, and they respond by purchasing more, as their real incomes improve thanks to productivity gains. Companies thrive because their earnings are boosted as they gain more unit sales growth than they lose on the pricing side.

Alternatively, ***Bad Deflation*** occurs when companies are forced to lower their prices, but unit sales don't increase enough to maintain profitability. In this scenario, companies respond to weaker profits by cutting employment and by reducing capital spending. The deflationary spiral starts spiraling as consumers become insecure about their jobs and reduce their spending. In the Good Deflation scenario, consumers view lower prices as a good reason to buy more. In the Bad Deflation scenario, they respond to lower prices by postponing purchases, figuring prices will be even lower tomorrow, when they might have

less uncertainty about their job security. Americans in the 1930s and Japanese in the 1990s experienced the bad version of deflation.

But why wouldn't unprofitable firms simple go out of business, leaving healthy firms in a position to enjoy higher prices once the excess supply is shut down? More often than not, the answer is corruption. Theoretically, in a free market, there is no protection from failure. In reality, all too often, insolvent companies remain in business. They may have highly placed political and business friends in the government or in their major creditors. Insolvent businesses—a.k.a., "zombies" or "the living dead"—can only survive and thrive in an environment of political rot, a.k.a., corruption. This Zombie Problem means that healthy companies are forced to compete against firms that don't have to be profitable to survive. Obviously, if the situation is allowed to persist, then it is only a matter of time before solvent companies become insolvent too.[9] This is the ***Ugly Deflation*** scenario.

Corruption is not the only source of Bad Deflation. An excessive supply of financial capital can also be a problem. In peace time, there is more money and credit available to finance private-sector business. The opportunities to prosper seem as big as the potential global market. Before long, there is too much money chasing too few good deals. Yet, prosperity tends to generate over-confidence and unrealistic expectations. Projected returns are overestimated, while risk is underestimated. As a consequence, supply tends to race ahead of demand. The resulting deflation depresses returns and, at some point, stops the free flow of financing. When this happens, even solvent companies may be forced to shut down if their sources of credit dry up. This is another version of the Ugly Deflation scenario, of course. What could be worse than to see well-run companies go under and fire all their workers because of an indiscriminate flight-to-quality in the credit markets? This happened in Asia in 1997 and 1998, and almost became a global problem during the summer of 1998.

What can policy makers do to avert the unhappy deflation scenarios? Here are five obvious policy responses:

1) Let insolvent firms fail. This is a major problem in many countries where there is a tradition of using government resources to protect companies from failure.

2) Establish effective bankruptcy laws and courts. Companies must have an orderly mechanism to restructure their business activities.

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[9] John D. Rockefeller observed, "often-times the most difficult competition comes, not from the strong, the intelligent, the conservative competitor, but from the man who is holding on by the eyelids and is ignorant of his costs, and anyway he's got to keep running or bust!" Quoted on p. 150 of Ron Chernow, *Titan: The Life of John D. Rockefeller, Sr.*, Random House, 1998.

3) Foster mergers and acquisitions of weak firms by strong ones. This is a major problem in many countries where there is resistance to letting strong foreign companies acquire weaker local ones.

4) Tighten and enforce bank regulation and supervision. Limit lending to insolvent companies. Require proper accounting for problem loans. The Bank for International Settlements compiled a list of sound banking practices last year.[10]

5) Require greater and more frequent corporate disclosure, i.e., transparency. Corporate laws and regulations should force directors to act in the best interest of their shareholders, who should receive the information they need to be assured that this is the case.[11]

The basic message is to allow market forces to reduce excess capacity quickly. Today, this is not happening quickly enough, in my opinion.[12] The reason is obvious: Such restructuring is painful. Initially, this approach worsens deflation by increasing unemployment and depressing spending. Instead, the preferred solution to the deflation problem is believed to be a painless easing of credit conditions through stimulative monetary policies. Central bankers hope that lower interest rates will revive demand enough to absorb all the supply. It is my view that this approach is bound to fail because it may very well prop up supply much more than it is likely to boost demand. Credit crunches are nature's way of cleaning out insolvent borrowers from the economy. Easier credit conditions may actually exacerbate the Zombie Problem. 1999 is likely to be the first deflationary year in many economies around the world. In 2000, a global recession caused by Y2K is likely to worsen the deflationary situation.

V. Internet

In the idealized model of Perfect Competition, there are no barriers to entry, no protection from failure for unprofitable firms, and everyone (consumers and producers) has easy and free access to all information. These just happen to be the three main characteristics of Internet commerce. The Internet is fundamentally deflationary. While current Internet

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[10] Basle Committee on Banking Supervision, "Sound Practices for Loan Accounting, Credit Risk Disclosure and Related Matters," Oct. 1998, (http://www.bis.org/publ/bcbs43.htm).

[11] Countries that have the best legal protection for investors tend to have the biggest capital markets and the least concentration of share ownership. See Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny, "Law and Finance," National Bureau of Economic Research, Working Paper 5661, Jul. 1996. See also their Working Paper 5879, "Legal Determinants of External Finance," Jan. 1997.

[12] See Sheryl WuDunn, "In Asia, Firms 'Fail' but Stay Open," *International Herald Tribune*, Sep. 9, 1998. Corporations are "failing" in record numbers, but many stay in business. "But governments and legal systems routinely protect tycoons from their own incompetence, setting the stage not for a Darwinian struggle but for the survival of the flimsiest." In many countries in Asia, the legal framework for bankruptcy is vague and loosely formed.

spending is still a small fraction of total consumer and business spending, it is having a very deflationary impact on pricing already, in my opinion. Increasingly, pricing is determined at the margin by Internet commerce, which is extremely competitive.

The Internet certainly has the potential to produce bad deflation by cutting out the middle persons in every transaction. The only sure winner is the household and business consumer. Cybercompetition will force producers to accept puny profit margins. The technological costs of staying one step ahead of the competition are likely to burn money at a ferocious pace. For example, Amazon.com's revenues have grown dramatically, but costs have increased even faster. While consumers win as consumers, they could lose as employees of companies that cannot compete in cyberspace.

The Internet lowers the cost of comparison shopping to zero. Increasingly, the consumer can easily and quickly find the lowest price for any good or service. In the cybereconomy, the low-cost producer will offer the lowest price and provide this information at no cost to any and all potential customers anywhere on the planet. In the low-tech economy, the cost of searching for the lowest price was relatively high, thereby limiting a customer's search process to local or well-established vendors. Now vendors anywhere in the world can bid for business anywhere in the world.[13]

The Internet is the "killer" application that will continue to boost the sales of computer hardware and software. It's the "got-to-have-it" tool and toy for the next century. Internet-driven sales of high-tech gear will generate the cash flow and attract the financial capital needed by the computer industry to develop even more powerful computers at constantly falling prices. More powerful computers permit software developers to create more powerful multimedia programs. These processing and memory hogs, in turn, force computer users to upgrade to the latest generation of hardware, which is required to run the latest versions of the operating systems and applications.

In Biblical terms, better computers beget better software applications beget more demand to upgrade to even better hardware and software. The Internet begets more upgraders and more newbies. One of the most unusual, and certainly most unique, attributes of the computer industry is that prices fall even as processing power soars and demand exceeds supply. In high-tech markets, falling prices are the reason why demand exceeds supply. But why do prices fall so rapidly in the face of booming demand? As soon as a computer chip is introduced, manufacturers are already developing the next generation. Innovators of generation "n" chips are forced to create "n+1" chips. If they don't, the competition

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[13] In Topical Study #31, "Economic Consequences Of The Internet," Oct. 22, 1996, I observed that the "The Internet is fast becoming a global auction market and could commoditize most markets for products and services." See also "Internet Is Opening Up A New Era of Pricing," *The Wall Street Journal*, June 8, 1998. The article notes that business-to-business commerce on the Internet is likely to dwarf the consumer sector.

soon will. This situation means that the most successful producers of technology must cannibalize their own products to remain successful. The high-tech industry literally eats its young.

The cost of high-tech research and development is so great these days that high-tech manufacturers must sell as many units as possible of their new products in as short a period of time as possible before the n+1 generation is introduced. That's why they tend to offer more power at a lower price with the introduction of each new generation. Also, the introduction of n+1 immediately reduces the demand for the *nth* chip and the *nth* computer. As the price of the old technology falls, it limits the upside of the price of the newest technology. As a result of these unique trends, the purchasers of high-tech hardware are constantly receiving more bang for their buck.

The plunge in the cost of computing power is probably the most extraordinary deflation in the history of this planet. In effect, the High-Tech Revolution has created a fourth factor of production–namely, Information. The original three factors are Land, Labor, and Capital. Factors of production are substitutable for each other. Until recently, Information was hard to substitute for Land, Labor, or Capital. It was very expensive to collect, process, and manage. There were usually long lags between the creation of the raw data and its conversion into useful information. The lags made the information less useful once it was available. It was old news by the time it was available to decision-makers.

With the High-Tech Revolution, enormous quantities of information can be collected, processed, and managed on a "real-time" basis at lower and lower costs. The price of information is deflating. As it gets cheaper and cheaper, it also becomes more substitutable for the other factors of production. Increasingly, real-time information is replacing labor and capital in the production process. For example, insurance companies can eliminate warehouses of archived files and the associated support staff with scanners that can transfer information to optical disks. The automakers have slashed their inventories with real-time information systems that can automatically place orders with vendors, schedule just-in-time deliveries, and monitor the transportation progress of the orders. As a result, inventories-on-the-shelves can be replaced with "inventories-on-wheels." Information replaces working capital.

VI. The American Challenge & The Euro

Of all the major industrial nations, the United States has responded best to the economic challenges of the post-Cold War world. That's mostly because 1) industrial deregulation has increased competition, and 2) labor markets have become more flexible in the United States. Labor markets 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. They accept the fact that job security no longer exists. Instead of automatic raises each year, more of workers' pay is in the form of incentives and profit sharing.

Most American workers are probably working harder than they did five or ten years ago. With the unemployment rate below 4.5%, they seem to have more job security. However, American workers recognize that, in highly competitive markets, there is no business security. They seem to understand the importance of keeping costs down to keep their companies competitive and to keep their jobs.

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—real limits on the social welfare state before it becomes completely bankrupt just in time for their retirement.

They made this quite clear during the November 1994 elections. The Democrats lost their stranglehold on Congress after the Republican's 1994 sweep. For the first time since 1948, Democrats held fewer than 200 seats in the House of Representatives. The results of the 1996 elections confirmed the sea change among American voters. The Republicans held onto both houses. Ross Perot's vote dropped from 19% to 8% of the popular presidential vote between 1992 and 1996. This was a clear sign that Americans had turned less protectionist. President Bill Clinton, a Democrat, shrewdly adopted the Republican agenda by pushing successfully for the North American Free Trade Association and welfare reform.

As Americans continue to shrink both the welfare state and reduce 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. 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.

European leaders hope that a Europe united by a common currency will emerge as a more competitive economic force in the coming century. European Monetary Union is a very daring economic experiment. The EMU has come to pass. It makes a great deal of sense by further pulling together a market of 292 million people. Indeed, it has already been a great success in Europe by lowering and converging both inflation rates and interest rates at very low levels. The euro is likely to force greater integration of Euroland's national economies by stimulating greater standardization, thus cutting the costs of doing business in the region and creating economies of scale. European capital markets will certainly be much more attractive to global investors who can now purchase the region's securities all in one currency. European entrepreneurs will have greater access to capital, boosting both the number of new businesses and employment.

Europe could stumble because monetary unification can't work very well without labor market mobility and fiscal unification, which is an important missing ingredient. More likely, labor markets will become less rigid as European companies pressure their workers to be more flexible or lose their jobs to workers in Eastern Europe, China, and South Carolina.

VII. Japan's Karaoke Capitalism

It certainly has been a new era in Japan since the stock market crashed at the start of the 1990s. It hasn't been a golden one so far. 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.

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.

But that was then, and this is now. Japan has only 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, and triggered a stock market crash. The resulting bad loans created a horrendous banking crisis, which is proving harder to fix than was the S&L debacle in the United States. Japan's policymakers not only failed to address this problem, they exacerbated it by propping up insolvent banks for almost a decade. Imagine how bad the economic and financial situation might be today in the United States if American banking regulators had propped up the S&L industry, instead of restructuring the industry.

Japan's leaders are once again promising to reform their political, economic, and financial systems. Many similar promises have been made before. They weren't kept.[15] The Liberal Democratic Party (LDP) deserves a great deal of credit for leading Japan's emergence as the second most powerful economic power on earth during the four decades following the end of World War II. However, in the 1990s, the LDP's policies have been disastrous.

The Japanese government, under the leadership of the LDP, has implemented several fiscal stimulus programs in the 1990s, presumably in an effort to revive economic growth. In reality, these expensive outlays have mostly enriched party members, their political cronies, and their supporters. The latest bank rescue plan and fiscal stimulus package are impressive in their size and scope. Over $500 billion in public funds will be used to restructure the banks. However, the risk is that huge sums of public funds will be used to temporarily ease the crisis without any meaningful reforms. In many ways, the banking problem has been socialized, without any clear plan to force better lending practices.

VIII. Emerging Economies: Something Missing

In some ways, the emerging economies of today in Asia, Latin America, and Eastern Europe 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.

There were at least two very important ingredients behind America's success story. The country had a dynamic 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

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[15] "Earlier this year, it seemed that a sweeping corruption investigation might send a number of Japan's mighty philosopher-kings, the bureaucrats who largely run the country, to prison. But these days, despite a cabinet change, nearly the only government employee who has gone anywhere is Katsuhiko Kumazaki, the prosecutor who led a much-heralded investigation into scandals involving expensive free entertainment paid for by businessmen who wanted the bureaucrats' favors. Mr. Kumazaki, 56, was transferred in June to a remote coastal city, and the investigation seems to have fizzled out." Sheryl WuDunn, "Japan Corruption Investigation Fizzles," *International Herald Tribune*, Aug. 15-16, 1998.

requirements of a dynamic economy. The rulings of the Supreme Court during most of the 1800s consistently favored the advocates of economic progress.[16]

Many emerging markets today don't have legal and regulatory 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. Insurrection is very unsettling to foreign investors.

Asian nations have some of the world's finest manufacturing plants and best workers, who are as productive as any in the industrialized capitalist economies of North America and Europe. Driven by the profit motive, Asians have prospered greatly over the past three decades. However, under the thin veneer of capitalism, there has been too much corruption. In the world's free markets for manufactured goods, Asians have been world-class competitors. But, at home, competition has been stifled. Asians have built the industrial and technological infrastructure necessary to sustain export growth. But, at home, there has been too little progress in establishing the legal, accounting, and regulatory infrastructure of capitalism necessary to sustain economic growth. Asia's prosperity has benefited mostly Asia's producing classes rather than the consumers. Asians have embraced free-market capitalism globally, while maintaining an antiquated culture of mercantilism and crony corruption at home.

This should all change for the better as a result of the Asian Crisis as capitalism triumphs over corruption in the region.[17] Many Asian nations are implementing reforms in response

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[16] According to Ron Chernow (*Op.cit.*, p. 297), "Standard Oil had taught the American public an important but paradoxical lesson: Free markets, if left completely to their own devices, can wind up terribly *un*free. Competitive capitalism did not exist in a state of nature but had to be defined or restrained by law. Unfettered markets tended frequently toward monopoly or, at least, toward unhealthy levels of concentration, and government sometimes needed to intervene to ensure the full benefits of competition. This was particularly true in the early stages of industrial development."

[17] Transparency International (http://www.transparency.de), an international good-government advocacy group based in Berlin, annually ranks the world's governments from most to least corrupt. In it's latest study, released Sep. 1998, the group found no improvement stemming from the World Bank and IMF efforts to reduce corruption by including anticorruption measures in their loan agreements. According to the group's latest Corruption Perceptions Index (1=least corrupt)—of the 85 countries surveyed—Indonesia ranks 80, Russia ranks 76, Thailand ranks 61, Mexico ranks 55, China ranks 52, and Brazil ranks 46.

to the region's financial and economic crisis. They are setting the stage for massive restructuring of Asian economies. Reforms will initially exacerbate Asian economic recessions. This will be painful as unemployment soars. But this is the only path to renewed prosperity.

A significant milestone in reducing global corruption will occur during February 1999, when the Organization for Economic Development and Cooperation will implement a convention that makes the bribery of foreign public officials to win or retain business a criminal offense in more than a dozen industrialized nations.[18]

IX. Conclusion

In 1919, John Maynard Keynes published a short book titled *The Economic Consequences of the Peace*. It was an emotional and vicious attack on the Treaty of Versailles, which he argued was imposing a Carthaginian peace on the Germans and would set the stage for years of economic suffering and political turmoil in Europe. As events unfolded, it was a remarkably accurate forecast. It was also a worldwide sensation. In fact, Paul Johnson suggests that the book turned US public opinion against the Treaty and the League of Nations. The Senate voted against the Treaty, and the overwhelming defeat of the Democrats in the autumn of 1920 was seen as a repudiation of Wilson's European policy in its entirety.

After World War II, many economists predicted a depression, or at least stagnation. They expected a slower pace of business during the peace. The stock market ignored these dire predictions. The S&P 500 index soared 139% from April 1942 to May 1946. Industrial production did dip right after the war, but the revival of consumer spending fueled a long period of prosperity until the late 1950s.

Fortunately for us, the economic scenario of the current peacetime is following the prosperity script so far. The US stock market is up a whopping 240% since the end of 1989. The end of the Cold War was a liberating event of historic proportions. The global economy was liberated from protectionism. The subsequent proliferation of free trade should continue to generate prosperity for Americans and all other humans on this planet who are willing to accept the competitive challenges.

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[18] OECD, "Combating Bribery of Foreign Public Officials in International Business Transactions: Text of the Convention," http://www.oecd.org/daf/cmis/bribery/20nov1e.htm

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