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Deflation or Structural Reorganization?

1. Developments that are hard to explain

Too good a memory among his readership would be the demise of the economic commentator. He counts on his readers' understanding as he declares yet again that the times were never as difficult as they are today. He who concerns himself with the future bases his ideas about probable future events on patterns - patterns that explain a portion of the past and which he believes are likely to play a role in the future.

And then one day he realizes that the established patterns no longer hold. An event occurs that does not fit the usual scheme, the statistics raise innumerable questions, and the analyses of professional colleagues diverge sharply. When this occurs, it is once again fitting to lament that these are "difficult times." We are at such a point today. Why?

- The last couple of years have witnessed the steady deterioration of Japanese stock prices. Since the beginning of the 1990s, the Nikkei-Index has fallen by more than half, in this year alone it has dropped further by more than 25%. What is noteworthy, or difficult to explain, is that over the same period of time (since the beginning of 1995), the Japanese bond rates experienced an unheard of growth of 10%. In other words, in a period of dramatically declining interest rates, the stock market was falling. That pattern does not conform to the most accepted understanding of the relationship between interest rates and stock prices. Difficult times.

- A strong economic upturn was projected for Europe in 1994 and the year's first numbers seemed to confirm it. An economic upturn would have fit the scenario so perfectly: After the 1993 recession an upturn, after the rain comes the sun. Wouldn't it be nice. Instead, very restrained consumption numbers, a retreating (in Switzerland) or sputtering (in Germany) construction and real-estate market, and current money supply figures all point to anything but a significant, stable economic upturn. The growth of the M3 money supply in Germany has long since fallen below the target range. In Switzerland the demand for credit is weak despite lower interest rates. And unemployment rates cling tenaciously to their high levels. Difficult times.

- We are also receiving extremely ambiguous signals from the United States. On the one hand, the world is no longer just talking of an economic "soft landing." There is now concern over the possibility of a new recession. Several important indicators (orders for goods, the labor market, production) actually point in this direction. Meanwhile, Wall Street is breaking all records. Admittedly, U.S. interest rates have fallen - in this case the mechanism "lower interest rates/better stock market" would appear to be working. But the curiosities go beyond this: Despite recessionary indicators, U.S. industries have dramatically improved their profit margins. According to the most recent measures, the profit-per-share of the 30 Dow Jones companies was about $110 in 1992, $250 in 1994, and is projected to be $300 for 1995. What do we make of recessionary indicators at a time of economic improvement? Difficult times?

- The universal and well-founded concern that arose in recent years in response to increasingly dangerous levels of public debt verged on becoming an obsession. But more recent statistics point to a pronounced reduction in national deficits, measured against gross national product. This is true for the United States, England, and even Sweden. The "peace dividend" and the accompanying reduction in military spending are not enough to explain this. Another basic structural evil, one which in the past was the subject of bitter complaints in the United States, also appears to be losing its hold on the economy: the notoriously low savings rate. Americans are saving $.50 of each additional dollar earned. That is more than ever before. What does it mean? Perhaps, less difficult times - for example, for the dollar?

2. Where experience is lacking

No matter how you look at it, these developments do not fit into a purely cyclical world view. From a cyclical perspective, the Japanese economy - where the discount rate has hit 1% - should have taken off long ago. The European "upturn" ought to be more robust and there should have been a cyclical reduction in unemployment. In the United States, a consumption boom should have followed the long period of military investment. Instead, the Americans appear to be learning to love to save. The most uncomfortable situation is no doubt Japan. That country is showing clear deflationary characteristics. Deflation is the situation in which a relatively large supply of money (thus, the low interest rates) is coupled with a low demand for goods. Japan has never before known unemployment. The Japanese person always assumed that once he had established an employment relationship it would last for life, or, in other words, beyond retirement. This dream has come to an end and the awakening has been harsh. People are instinctively doing what comes most naturally: they are saving. As a result, demand is strangled further.

The surplus supply of goods has a notable effect in the real-estate sector. Real estate prices, which for a long time seemed to us to be dizzyingly excessive, have melted away. But now the most essential basis of credit in the Japanese financial system is threatened. Asset rich Japanese firms' cherished practices of clustering and stockpiling reserves (typically, dividends were not paid out, but instead were held as hidden reserves) are turning out to be a system threatening swamp of as yet undetermined depth. Under these circumstances, the high flying Yen only further dampens Japan's already anaemic economic growth.

Can all this leave us unfazed? Clearly not if, for example, one considers that the Japanese stock market, despite its recent set-backs, remains larger than all the European stock markets taken together. Our problem is that we lack any experience in handling deflation. A comparison with the early 30's (as popular as it may be with doom-sayers) is hobbled from the outset by the fact that today's financial markets, with all their instruments and sophisticated communications technologies, create a completely different point of departure.

The recipes for dealing with deflation are as unclear as the escape from an inflationary spiral is difficult. Interest rate reductions alone apparently don't help very much. We assume that the Japanese government and its central bank will have to pursue a stimulus package aimed at: devaluing the Yen, implementing long overdue deregulation initiatives, providing consumption promoting tax-breaks, bringing about flexibility in the employment market, and, unavoidably, to some extent reflating the economy.

Given the far-reaching implications of such a stimulus program - in many respects it means bidding farewell to "Japan Inc." - the point at which it will be initiated is entirely unknown. The Nikkei-Index could first fall to ten or twelve thousand points. Difficult times.

3. An unrecognized structural reorganization process

The contradictory data in the United States is particularly difficult to interpret. It is apparent that simple cyclical explanations are inadequate. For a long time, the statistics-revering experts, who spend most of their time maligning each other, completely missed the fact that substantial new economic capacities were forged in the United States over the last two years. These capacities grew not in the traditional sectors, but principally in the communications sector - the point at which service provision and goods production increasingly intersect and where, as a result, traditionally-thinking economists run into classification problems. In conjunction with the underestimation of the build-up in capacity came an overestimation of the danger of the economy overheating. The thinking was simply based on out-dated capacity limits. As a result, it was predicted that strong economic growth would have to lead to a tightening employment market and, in turn, to greater inflation. Last year's worldwide interest rate hike occurred in part thanks to this mistaken estimation.

If one interprets the United States' strong economic upswing of the past two or three years not as a cyclical development but instead as reflecting a new structural order, then all of a sudden many of the current statistics make sense. The strong growth in corporate profits, for example, is the result of structurally conditioned investment activities; the corporations and not the workers are the principal benefactors of the new growth in productivity. That is why the U.S. upturn did not yield any noteworthy improvement in the income level of Americans. This, in turn, explains why consumer demand did not develop to a cyclical high. The increase in the marginal savings rate among Americans can also be explained against this background. In other words, a non-cyclical, structurally conditioned upturn leads, at least in an initial phase, to a de-coupling of overall economic growth from the growth of private disposable income.

The far-reaching consequences of this structural transformation cannot be emphasized enough. What is happening in the communications sector today is comparable to the Industrial Revolution of the last century. The effortless networking of the entire world puts the economy in a position to overcome all traditional barriers ("structures!")and fully utilize its particular capacities. It is apparent that the communications revolution will be no more hampered by political barriers than by any others.

In the United States, a portion of this quantum leap has thus already been taken. As a result, we are sceptical of cycle-based arguments over whether the economy is more likely to experience a hard or soft landing. It is much more likely that in the framework of the communications revolution, those sectors participating in the revolution will continue to see their capacity grow briskly, while "old" sectors stagnate or even face crisis. Consequently, the economic indicators (principally designed for business-cycle explanations) will most likely alternate up and down. Professional pundits struggle in times like these - pretty trends are a thing of the past.

What is the result? Growth rates will vary from sector to sector. A lack of unambiguous economic indicators will lead to uncertainty in the financial markets. The political class will fumble awkwardly as it tries to navigate a world that, seemingly inexplicably, is characterized by increasingly inconsequential traditional authorities. It will be a world of enormous long-term social transformations because, over time, there will be certain hardened structures that the "winners" will no longer accept. The communications revolution will have its victims. And in our opinion, it is apparent that among the victims will be the excesses of the social welfare state.

4. Europe: Between the USA and Japan?

A cyclical explanation of Europe's rather mild upturn is not very revealing either. If, for example, one looks at Switzerland's building and real estate sector, the current structural transformation and the deflationary tendencies are altogether too apparent. At the end of the eighties, Swiss real estate prices were still such that, aggregated, they theoretically made it possible for our country to sell its various properties and live off the interest. The interest from the proceeds of the sale would have nearly equalled the gross national product!

Of course, the reduction of such an extreme over-valuation can accelerate an already over-due structural reorganization. In this country there are very few builders who are not also invested in real estate. Deflation means the devaluation of goods. What was "worth" 1000 SF per square meter yesterday is, in some places, only worth 200 SF today. Under these circumstances, low interest rates help very little.

What is particularly true for this one sector has implications for the interpretation of the overall economic numbers as well. It creates the appearance that Europe was much less successful in increasing productivity than was the United States. And perhaps of more far-reaching consequence in the middle-term is the fact that while productivity increases in the United States were followed by reductions in unemployment, European unemployment rates remain steadfast at unequalled heights. Presumably, the politicized structures of the European labor markets have prevented an adjustment to current conditions.

Against this background it also becomes clear why this "upswing" is proceeding in fits and starts. In the midst of an industrial revolution, one can't expect a cyclical upswing to take hold. And it is pointless to speculate about when the consumer will finally think to really consume again. The more appropriate question is whether Europe can prepare itself in time to participate in the communications-based structural transformations. If one considers the number of monopolistic structures in the long distance and media sectors, then there is cause for concern. And if, in addition, one considers the relatively centralized-mercantilistic orientation of the EU, then the question of whether Europe will be able to manage the structural changes in time becomes even more critical.

5. Consequences for the prediction of crucial economic values

Let us start with the positive: The described situation does not in any way point to there being a danger of new inflation. This is true in Europe as well as in the United States, even if in the U.S. the rate of cost increase promises to be around 3 - 4%. In Switzerland, if one controls for the effect of the new value-added tax, we are currently experiencing price reductions. And inflation is not even a consideration in Japan.

With that said, it follows that surprise upward movements in interest rates should be out of the question. It is possible that U.S. bond markets might get nervous if several economic indicators perform "too well" again. And given the tendency toward hysteria within the global finance system, these developments might cause local bond markets to suffer temporarily. But there are no macro-economic grounds for interest rate hikes. The question arises as to how much further interest rates could sink potentially. In the case of an economic slide, à la Japan, interest rates could quite possibly go below the traditional limits (SFr. 4%, DM 5.5%). If the inflation rate were to stay fixed at zero for an extended period of time, then interests rates would settle at a new, lower structurally reinforced equilibrium. Nominal interest rates are, as we know, made up of a real interest rate plus an anticipated inflation rate. A persistently low rate of inflation must lead to a downward adjustment of the anticipated inflation rate.

Unfortunately, the rosy prospects for interest rates do not allow us to conclude the same for the stock markets. Japan demonstrates just how bad things can be for an index at a time when interest rates are at an absolute low. Stocks ultimately are always a reflection of the anticipated development of a business, and in times of structural transformation there are necessarily both winners and losers. If the chances are good that a transformation will succeed, then the stock market experiences the best of times. The current level of the Dow Jones Industrial Average can be interpreted in this way.

6. Capital versus earnings

We are not yet practiced in handling deflation and structural transformation. We developed our economic understandings from the cyclical ups and downs of the '70s and '80s. Japan is in a deflationary state, the United States is experiencing a dynamic structural transformation, and Europe stands somewhere in the middle. If we want a compass to guide our economic endeavors, we will do better to rely less on cycle-oriented empirical information and more on good old fashioned economic common sense.

Deflation means that there is a low demand for goods. Their decrease in value is a logical consequence. If this is so, then one is well advised to look carefully at those entities with which one is considering establishing an economic relationship. A study of the hidden reserves of Japanese firms makes clear the importance of such an analysis. The "meat that was on the bone" five years ago has vanished. We direct your attention to the graph in the yellow section of this Commentary titled "Investment Policy."

Doing a thorough analysis of a possible economic partner at a time when he is not simply getting richer by sitting there is a strategy that should be applied to bond debtors of every sort. We explicitly include state-debtors in this statement. There remain few if any overriding world-political reasons to protect state-debtors from the consequences of their inability to pay. The Mexico crisis was perhaps a last exception carried out according to the old patterns. We could be facing a future of state bankruptcy. By the way, this is a valid means of forcing the rapid transformation of outdated structures!

Credit ratings are, thus, of paramount importance. But what does credit soundness mean when the foundational economic structures are transforming? Clearly, it is the likelihood that a debtor will be able to generate future positive cash flows with his economic endeavors. Thus, above all one should be warned against so called "capital gems." What good are land reserves and palatial offices on Zurich's Bahnhofstrasse and Fifth Avenue if those things will no longer generate earnings? Land is in abundance around the world, as are willing labor forces. And a growing number of consumers would prefer to do business with an intelligent supplier in an open meadow than accept the excessive margins of a traditional company.

In a time of structural transformation, a credit rating, understood as an analysis of the potential for future cash-flow generation, has implications for both believers in bonds and for stockholders. Everyone has to do their homework. Past balances and win-loss calculations are less interesting than estimates of whether a company's management has the capacity to survive the economy's structural changes.

Admittedly, these are difficult times. But they are also challenging and pioneering times.