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Are the Markets too Powerful?

1. *The Euro: Overestimated Monetary Risk*

Hardly a day goes by that a new comprehensive study of the introduction of the Euro does not land on our desk. The last time we explored in depth the topic of the European Monetary Union (EMU) was September 1995. Since then we have largely avoided any extensive reevaluation of the situation. In 1995 we established that there were essentially three paths along which the EMU could develop:

a) the monetary union could become an opportunity for a broad European economic upswing, brought about by the definitive dismantling of national trade barriers and the elimination of currency risks;

b) the monetary union could become a Pandora's Box of political turbulence and dangers within the European Union and, in turn, be the cause of a long-term destabilization of the European economic and currency systems -- the ultimate consequences of which would be difficult to predict;

c) the EMU could remain a utopian vision, always out of reach, because the criteria for monetary union spelled out in the Maastricht Accords will never be satisfied by a sufficient number of European states.

Not much has changed since we first spelled out these three possible scenarios for the EMU. All three possibilities continue to have some chance of becoming reality; no irreversible course has yet been laid in one direction or the other. Despite the fast approaching implementation date, even the scenario of the EMU remaining an out-of-reach ideal continues to be a very real possibility.

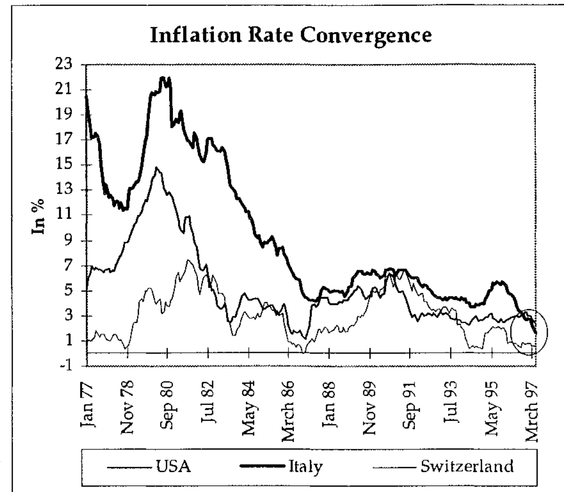
Nonetheless, at the moment, the majority of analysts and experts are proceeding on the assumption that monetary union will be implemented on time. They are of the opinion that we should anticipate a "big" solution. In other words, they expect that countries whose level of compliance with the Maastricht criteria is rather dubious will be included in the monetary union along with the "core" countries like Germany, France, Holland, Luxembourg, and Austria. Paradoxically, this is considered likely not because the "peripheral" countries have significantly improved their compliance with the criteria but rather because of the dramatic decline in the situation of what, until recently, was the EU's model member, Germany. Under the current circumstances, without a very generous interpretation of the Maastricht criteria no monetary union would be possible at all.

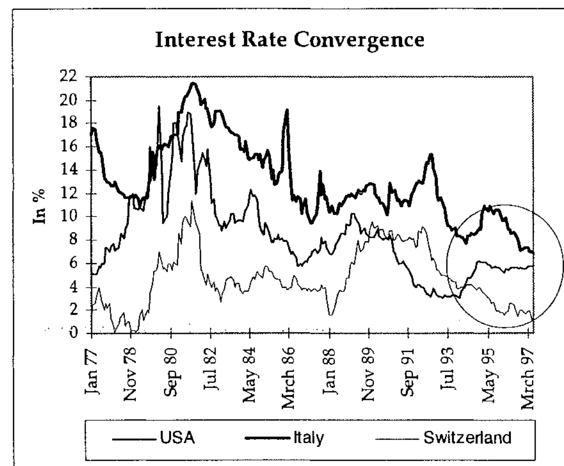
In anticipation of this "big" solution, a widespread fear has emerged that the Euro will turn out to be a constitutionally weak currency; analysts imagine that this will be the result of incorporating too many problematic countries into the monetary union. At first glance, such a conclusion may seem appropriate. We are of the opinion, however, that one should not jump to any conclusions just yet. Does it really make sense, for example, to sell all DM bonds

and turn one's attention completely to the Swiss Franc or the U.S. Dollar?

Two things must be taken into consideration. First, a priori the only group of people who will necessarily have a problem with a weak Euro are those who do not also have liabilities in this same currency. What is the point, for instance, of a German investor hurrying to liquidate his DM assets when from now on he will have to pay his living in Euro? The person who thinks in terms of German Marks because he is at home and works in Germany will later have to both think and pay in Euros. If he invests in a foreign currency, like the Swiss Franc or the U.S. Dollar, he will build up a significant currency risk regardless of whether the Euro turns out to be "hard" or "soft" (there is, after all, no way to be certain!). Investment problems should always be approached with an eye toward both the asset and liability side of the balance sheet. In many cases it may well be questionable whether the accumulation of currency-based balance sheet risk is warranted. We are particularly concerned to bring accross this point to our German readers.

Second, we question generally just how much maneuvering room a European monetary agency will have if it seeks to introduce a soft Euro. Our observations over the past few years suggest that the increased pressure created by quite efficient financial markets -- one significant manifestation of which are the very cost-effective derivative financial instruments -- has led to a structural convergence among the primary currencies of the world. The following two charts reveal this trend quite clearly for two of the primary determinants of the currency structure, the inflation rate and interest rate trends. We doubt very much that this movement toward increased discipline and convergence can be traced back to an intentionally formulated and internationally implemented policy pursued by fiscal and monetary agencies. Instead, a good deal of evidence supports the explanation that the current trend toward fewer monetary policy shocks results from the fact that any deviation from virtuous monetary practices is immediately punished by the interest rate and currency markets.





From our perspective, there is little reason to think that the Euro -- assuming it is introduced -- will not also be subject to the structural pressures of the global financial markets. Or put differently, we can assume that a European central bank, like it or not, will have to conform to the same new laws of the market as, for example, the German Bundesbank and even the Italian Central Bank. In fact, it is reasonable to assume that a European central bank would have even less maneuvering room than any particular central bank in Europe. After all, it matters to the financial markets whether it is "just" the Lira or the Peseta that is destabilized or whether a Europe-wide currency is threatened. Thus, from a currency perspective, we want to advise against excessive fear of the Euro, regardless of how large or small the circle of participants in the EMU ultimately turns out to be.

2. *Underestimated Political Risks!*

In the long run, the markets are simply too powerful to allow a weak single European currency. The predictable dip at the outset of the new currency order would quickly have to be corrected through stability-oriented monetary policy. Among other things, this suggests that a reflation in Europe would be relatively unlikely in the event of the implementation of the Euro. It is precisely this point which holds the key to understanding the political uneasiness associated with the proposed EMU.

Let us begin with France. The justifiably disappointed French voters recently ousted the Government of Prime Juppé. While his administration professed to be liberal, its economic policies were in fact thoroughly etatistical and un-liberal. Despite his comfortable majority in parliament, Juppé failed to conceive of and implement policies to take advantage of the free global markets. As a replacement for Juppé, the French elected a left-wing government which is essentially promising to address the country's major unemployment and economic stagnation problems using old socialist concepts. Every observer of the situation knows that this will not be possible without stimulating demand. Given the amount of pressure he faces to deliver, and deliver quickly, newly appointed Prime Minister Jospin will need to ignite the economic equivalent of a brush fire in order to make good on his promises in time.

But as the precursor to monetary union, the Maastricht criteria represent as significant a barrier to Keynesian policies as they do to monetary union itself. Jospin actually needs to be able to devalue the French currency; and in the past, that is to say before the idea of a European monetary union was concretized, devaluation presumably would have occurred without delay. The differences of opinion which emerged -- despite tedious attempts to obfuscate them -- at the most recent summit in Amsterdam are indications of the growing potential for political tension created by the prospect of the EMU.

What we are witnessing are the consequences of the fact that, through the unshakable belief in the creative power of the political the practical sense of what is doable was lost. All we have to do is consider the significant factual differences among the EU member nations with respect to taxation policy, economic policy, social policy, unemployment rates, black markets, and informal labor etc. etc. How does one come up with the idea to unite that which so clearly does not (yet?) fit together?

3. *Hostile Times for the Social Market Economy?*

This beachline may sound somewhat superficial. When efforts were first initiated toward establishing an economic and monetary union no one could have foreseen the speed and extent of changes that would occur in the global economic system. It is no exaggeration to say that many institutions have yet to fully recognize the structural transformation that has been occurring for the past three years. What are its principal features?

For one, the amount of work available globally has increased about five-fold in the last couple of years. This is a direct result of the demise of the Soviet Union: As the iron curtain came down, and the borders of Eastern Europe opened, the former East Block nations gained access to the global markets. At the same time, and perhaps even more significantly, the Soviet Union's demise brought an end to the constant military threat in most of the developing countries of Latin America, Africa, and Southeast Asia -- since then, it no longer takes excessive daring to invest in these countries and, in turn, to produce in them.

In addition, the multiplier of work -- productivity -- has been enhanced through immense advances in computer and communications technologies. Here too there is often incomplete recognition of the dimensions and implications of this change. No one can completely anticipate what will be the long term consequences of the intensive global use of the internet. But problem-free and cost-effective access to any data around the globe (e.g. libraries, catalogues, specifications, statistical data, etc.) and the equally efficient global exchange of information have eliminated numerous difficult and expensive tasks while at the same time making other activities -- like the large scale outsourcing of work -- possible. There is

no foreseeable end to this development. The European economies and their social welfare systems were, and continue to be, predicated on the assumption that work is relatively scarce and expensive. Unemployment insurance is designed to keep the price of labor (i.e. wages) from declining when demand changes; excess labor is simply removed from the market. In addition, many social programs are designed such that their financing depends upon the level of wages paid. These features fit very poorly into a world in which other people are prepared to offer comparable quality work at a lower price.

The European welfare systems also suffer from an additional structural weakness. Birth rates have been declining for some time while life expectancy has increased. An ever growing number of retirees have to be supported by progressively smaller younger generations. A somewhat simplified argument would thus be that these welfare systems (barring a reduction in benefits) cannot survive without an inflation-driven rise in employment and wages or an enormous in-migration of low-wage workers who can help fill the existing generation gap. But the political consequences of such measures would be difficult to anticipate...

The financial conditions of even the previously stable countries, like Germany, unmistakably point up a rather hopeless situation. In the current institutional context of high national debts and withering social welfare systems, Europe needs inflationary growth. But the markets and the market-dependent Euro will not allow this. That is why, without an extraordinary show of political strength to meaningfully reform the social welfare system and employment markets, we cannot expect a return to calm in Europe any time soon. The long-term trend toward a strong Euro will make it largely impossible for the EU as a whole, or individual national governments, to try to solve their problems monetarily (i.e. through excessive money creation). The only remaining option is a politically devastating ordeal, perhaps even a national bankruptcy for the most vulnerable member nations. Such a scenario was recently postulated at a conference on monetary policy by the British economist Goodhart (NZZ No. 144, June 25, 1997).

4. What will become of Country Risks?

There is another related consideration having to do with the introduction of a monetary union. In previous regimes, the national currencies and the currency-specific interest rates served as an expression of each country's risk. The Drachma, Lira, and Peseta offered higher interest rates than the Deutschmark or the Dutch Guilder and they tended to oszillate across a much wider range. In anticipation of the EMU, there has been considerable convergence.

Will Country risks be eliminated as a result of monetary unification? The portfolio theory suggests that non-correlated risks will, at least in part, be eliminated. That is to say, the EMU will create a diversification effect. A company who regularly takes on Italian assets, and thus has to carry Lira-specific risks, will be better positioned thanks to the diversification effect created by the Euro's incorporation of multiple, counter-trending, currencies.

However, that will only be part of the story. Country risks previously expressed as currency risks will now be manifested at the level of the individual borrower, unless of course the EU assumes credit risk. Maastricht explicitly prohibits the EU from assuming risk as a way of averting national bankruptcies (i.e. bailouts). Just how lasting this position will actually be is something we can only speculate on. Nonetheless, we assume that private borrowers will be forced to carry at least a portion of their particular Countries' risk. Their refinancing costs will thus include a country-specific risk premium. Outstanding bonds from debtors in high risk countries will lose value in the amount of this premium.

With respect to refinancing in the individual countries, we can look forward to some interesting times. In the earlier cited paper by Goodhart, the author points out that the U.S. state of Louisiana has received a "Baa1" bond rating from the rating agencies as a result of its 11.5% debt burden (debt service expenditures as a percentage of state revenues). As a consequence, the state is forced to pay higher interest on the money it borrows. Meanwhile, the

comparable figure for Italy is 50%, Belgium's is 46%, and Spain's is 29%...
One thing is clear: The markets are too efficient and too powerful to be deceived, even by the most creative institutional maneuvering. Across the globe, hundreds of thousands of pairs of eyes are watching around the clock to control whether some debtor somewhere has set a risk level too high or too low. Capital streams flow back and forth and eliminate any imbalances. Information -- in the form of up-to-the-minute news -- is thus disseminated and put to use in a highly efficient manner; more efficiently, at least, than any sleepy-eyed state run intelligence agency could manage. Why? Because money, a lot of money, is at stake in this type of news dissemination and application. The money belongs to investors, and we know of no investor in our world who wants to lose money.

We assume, therefore, that within the context of a single European currency there will be increased differentiation among the various classes of credit-quality. The concept of ratings, which until now was more widely applied primarily in the United States, will become increasingly important in Europe. Rating agencies will find a big market for their services on this continent. And we can easily imagine that debtors like the City of Naples or the City of Brussels will receive worse grades than large private borrowers, like Pirelli or Solvay for instance.

5. *A Secular Shift of Power*

It is not surprising that as economic and monetary control functions are taken over by the financial markets, those who have traditionally had the job of twisting the many little regulatory screws and pulling the many little steering levers are beginning to resist against their continous loss of power. The World Bank's most recent report (World Development Report 1997), which calls for the strengthening of public institutions in order to keep the markets on a virtuous path and to prevent "market failures", has to be understood in light of the secular shift in power away from public regulatory institutions. The World Bank belongs to this category of institution, and it is the World Bank itself which is responsible for many of the problems in the developing world; those problems are the result of government failures, not market failures.
No day passes on which "the markets" (whoever they may be!) are not held responsible for some awful occurrence. The Mafia in Russia -- a market failure! Price inflation in the healthcare industry -- the profiteering of greedy pharmaceutical companies! Unemployment in Europe -- insufficient regulation of the labor market! No accusation is too absurd, or too illogical, to be excluded from the columns and news items of even the most respected newspapers and media. The call for "good governance" is growing louder again. Why? Because the intelligentsia, the regulators, and the politicians can all feel their power eroding away.

Are we witnessing the final defeat of socialism, the "lifting of the socialist blanket" as Paul Craig recently predicted in Business Week (June 2, 1997)? Or is this just a fantasy that happens to be shared by us? Maybe. But it may also be much more than a fantasy. And if so, this is of major significance for investors. Based on the macro-economic data from the recent years, we believe that the power shift away from intentional steering and regulatory politics and toward the invisible hand of the financial markets is very real and in full gear. How else can one explain that, in contrast to the '70s and early '80s, we have not experienced any periods of double-digit inflation? How else can one explain that the growth rates of the individual domestic economies have smoothed out so much?

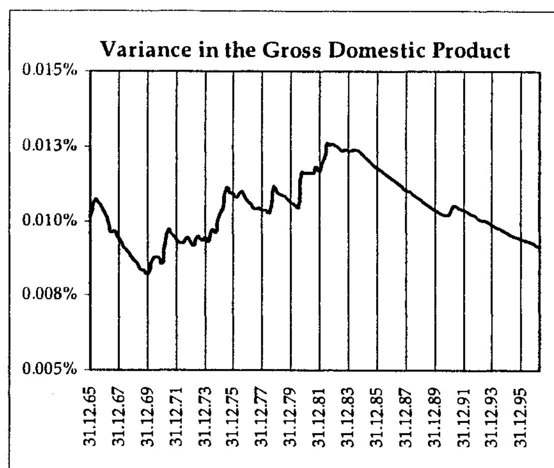
Inflation can be understood as an instrument for taxing the citizens. When the normal means of raising taxes to pay for state expenditures are no longer sufficient, inflation is an elegant way to reduce state debt and to raise taxes indirectly thanks to progressive tax scales. Inflation does not require the approval of parliament, much less a referendum. The forced relinquishing of this instrument by the efficiency of the financial markets has deprived the political sector of one of the principal tools with which it has traditionally expanded its power. The end of inflation is simultaneously the end of socialist dreams. No wonder is there hesitance from the holders of this vanishing power.

6. *Are the Markets too Powerful - are Stock Prices too High?*

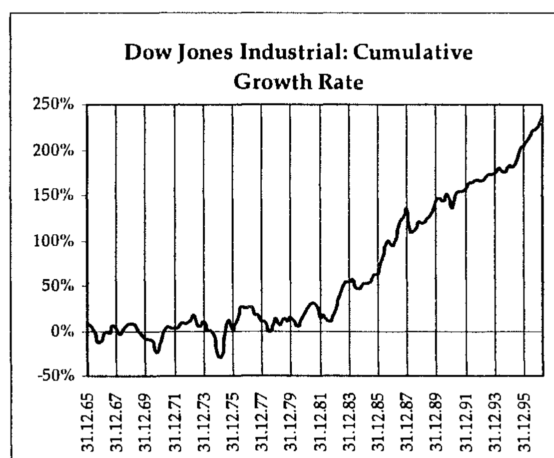
Assuming that our thesis is correct that the efficiency of the financial markets now has future monetary policy firmly under control, one would predict that the inflation premium for money must disappear and that the range of fluctuation in interest rates will decrease. Low interest rates and relatively greater certainty about future interest rate trends would be the result.

If one views shares as the claim of the stock holder against a company's future cash flows, then the question of future interest rates is of central importance. The current value of the stock reflects the present discounted value of future cash flows. Whether future earnings are discounted at a rate of 2, 4, or 10 percent is critical; the lower the interest rate, the greater the present value. It matters as well that most companies are more or less heavily geared. The interest rate charges of their borrowings are also determined by the current interest rate; the lower the interest rate, the lower the costs of debt financing and the greater the value of the company.

The likely demise of the "inflation tax" leads almost automatically to higher stock prices. We believe that the available data provide initial empirical support for our thesis. The following chart displays the variance in the change in quarterly gross domestic product (GDP) for the United States over the last 30 years. By variance we mean the range of change in growth rates: Large growth rate differences indicate periods of overheated economic growth followed by deep recessions; these differences produce high levels of variance. The first thing to notice is that during the '70s the rate of variance was high. This substantial level of variance is explained by the "stop-and-go" policies pursued by the Fed during that period. Since the beginning of the 1980s, the level of variance in the GDP has declined steadily. The trend in the consumer price index (CPI) is approximately analogous during the same period: Wild variation in the '70s, decreasing variance in the '80s, relative constancy since 1990.



To further support our analysis, we have charted the trend in stock prices using the growth rates of the Dow Jones Index. During the 1970s, the stock market, despite several ups and downs, basically remained at the same level. Not until the '80s do we observe a marked and steady upward trend. In other words, there appears to be a relationship between the amount of variance in the domestic economic growth rates (as well as in inflation rates) and the trends on the stock market. It is not difficult to anticipate such a relationship using economic theory. Because future growth rates are more predictable, there is a positive incentive for investment.



Our presentation belies any proposition that suggests stocks are good protection against inflation. The opposite appears to be true: In the inflationary '70s, investors earned nothing from stocks. By contrast, ever since inflation rates have declined, the stock market has climbed. If one accepts that the trend toward a smaller range of fluctuation in inflation and

domestic economic growth rates will continue, then the current levels in the stock market are at least justified. In fact, one could reasonably proceed on the assumption that considerable untapped market potential remains, given that popular wisdom has not yet accepted the idea of "low inflation and steady growth."

Of course, one certainly could reject our model for the explanation of the current stock market trend. Instead, one might want to argue psychologically and say that the current phase is simply a reflection of "a lot of momentum", that there have been "signs of nervousness", and that recently several "speculative bubbles" have developed. We admire analysts who can work with this type of models and derive from it consistent forecasts. But this is not our way of thinking.

7. The Stock Market as the Beneficiary of the Power Shift

Markets that are very powerful -- markets that structurally inhibit inflation and thus fundamentally challenge the survival of excessive state expansion and bloated social welfare systems: Is this just a mental exercise invoked to explain the sustained growth in the U.S. economy, the continuing recession in Europe, the record low interest rates in many important currencies, and the baffled disposition of the political intelligentsia in the face of rapidly emptying state coffers and disappearing social welfare funds?

We consider the thesis to be much more than a mental exercise. After all, one would otherwise have to be able to come up with other equally consistent and encompassing explanations for the listed phenomena. And one would also have to identify alternative models for the impact of recent innovations and investments in computing and telecommunications.

If we therefore hold on to our thesis, we can also continue to maintain our position that stocks are a sensible investment. Why? For one, our model does not suggest that the current -- by appearances quite high -- market levels are in any danger to collapse. If interest rates remain constant and corporate profits continue to show robust growth, we still may observe the inevitable market fluctuation (in the range of plus or minus 15%) but we do not anticipate anything more severe.

In addition, it should be apparent that corporate profit margins will be among the chief beneficiaries of a process that deregulates employment and challenges excessive government spending that is financed through exorbitant taxes and inflationary policies. Corporate profits and stock market trends are fundamentally linked.

The power shift away from the political arena and toward the economy would give the concept of equity investments -- a practice that is being promoted these days even in Germany and which pension funds and private investors are engaged in as they build up their stock positions -- a whole new and very interesting socio-political dimension. The distribution of the economic surplus would no longer be undertaken by the inefficient state-run distributive bureaucracies, but rather it would occur via the stock market and take the form of capital gains.

From this perspective, the current strength of the stock market takes on a ethical dimension as well.

KH, 11.7.1997