

How real is the deflation danger?

Amid growing signs of recovery, it takes a real Cassandra to warn of recession — or worse. But what if the gloomsayers are right?

BY ALYSSA A. LAPPEN

How sunny the U.S. economic horizon appears to be. Interest rates are about the lowest in 30 years, and America seems to be growing again, modestly but resolutely. The stock market, bolstered by November's tonic of a correction, is poised to resume one of the longest bull runs since World War II. The doleful drumbeat of corporate layoffs is actually the hopeful rumble of economic revitalization, as once-sluggish enterprises whip themselves into shape for the new era of global competition. Jobs? "The U.S. has created over 1 million new jobs in 1993, and the average per-capita income is rising," crowed T. Rowe Price Investment Services chief economist Paul Boltz in early November.

As for inflation — that spoiler of so many past recoveries — the consensus seems to be that it will remain in the quite-comfortable 3-to-4-percent range for the foreseeable future. "We've inherited low inflation from a set of past forces, which means we could still have a pretty decent situation if we don't blow it," contends Dreyfus Corp. chief economist Richard Hoey. A few pundits even go so far as to say that the underlying outlook has rarely been so rosy.

Let's hope, fervently, that they're right — but what if they're not? What if the economists, including Federal Reserve Board chairman Alan Greenspan, who are preoccupied with squelching even a hint of renewed inflation, have got it all wrong? Inflation is like blood pressure — it's good that it's low, but only up to a point. Suppose the real risk is not inflation, but *deflation*, even depression?

Pension officers and money managers would be unwise to discount this possibility entirely. During the Great Depression, interest rates and equities *both* fell off a cliff. A repeat performance today would savage the stock values in defined-benefit plans and mutual funds alike. And the increasing credit risk, which managers are taking as they reach for yield, would undoubtedly hurt, too.

"It's silliness on the part of the Fed to worry about a reignition of inflation," argues Philip Braverman, chief economist and senior vice president of DKB Securities in New York. "We're at the battlements guarding the front gates, when the real danger is coming in the rear." As Braverman and a lonely band of economic contrarians see it, the demon that has crept inside the door is falling prices. "We are *in* a depression that has been contained — disguised and softened by a lot of factors," Braverman maintains. "We face a period of adjustment that will take years to resolve."

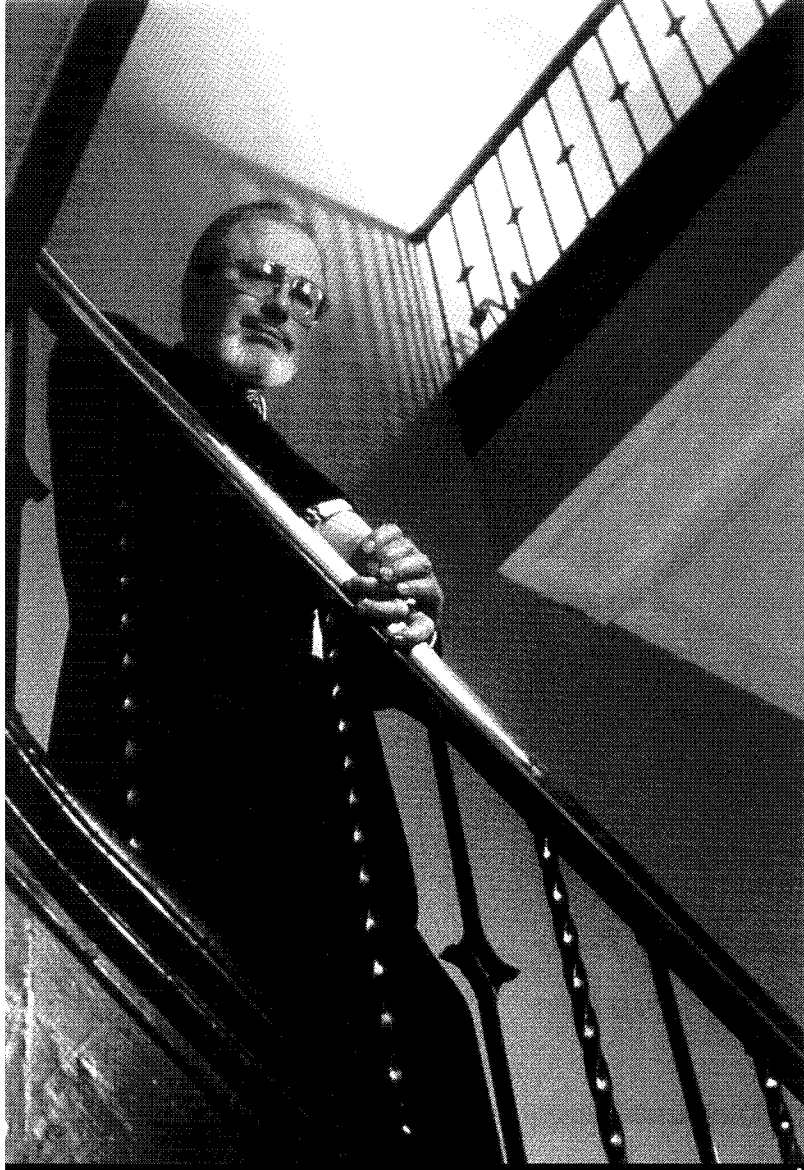
Yet so eccentric is such a deflationary view that many main-



Giorgio Palmisano

HSBC Holding's Hunt: "Weakness has passed from one international center to another, so there is no recovery that amounts to anything in Japan, in Germany or in the U.S."

stream economists dismiss it as, well, nuts. To a question about whether there might not be some pent-up potential for deflation, T. Rowe Price's Boltz lets out a raucous laugh. "That is the most preposterous thing I ever heard," he says. Murray Weidenbaum, director of the Center for the Study of American Business at Washington University in St. Louis and the first chairman of president Ronald Reagan's Council of Economic Advisers, gravely notes: "Inflation is low, but it is not dead. If you walk away from the battlefield, you lose." And former



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al center to another, so there is no recovery that amounts to anything in Japan, in Germany or in the U.S." Hunt attributes the situation partly to the anemic 3.5 percent current annual growth in the money supply among the Group of Seven nations. "The growth of this measure of money supply going back to 1970, the first time it was available, has averaged 12 percent," he says. "The rate in 1993 was the lowest on record."

The weighted-average industrial production of the U.S.'s six largest trading partners has registered its second-steepest decline since 1952. But whereas the sharper 1974 drop experienced by Japan, Germany, the U.K., France, Italy and Canada reflected the Arab oil embargo, Hunt says, the current slackening is broadly economic in origin. In the U.S., order backlogs declined for eight months through last October, reports Robert Parks, a veteran Wall Street economist.

Broader geopolitical trends are at work here, say deflation watchers. The end of the cold war has freed up hundreds of millions of surplus workers in Eastern Europe and China who are willing to labor for \$1 an hour or less. That's already putting implicit pressure on industrial-country wage scales, and the effect is compounded by the expanding availability of cheap labor in the emerging free-market economies of Latin America and the Pacific Basin. Now comes the North American Free Trade Agreement and the General Agreement on

Tariffs and Trade.

The last time a huge glut of laborers entered the free-world markets was after World War II. Then the U.S. managed to harness these soldiers-turned-workers to its own and the world's economic advantage through the Marshall Plan and the American occupation of Japan. Pent-up consumer demand empowered the economy with the help of savings and credit. And the continuation of war — albeit cold — fueled military spending that acted as a great Keynesian pump, priming the growth that began during the war and lasted, with what look in retrospect to be relatively minor interruptions, into the 1980s.

In 1994, one might argue, the victims of the cold war and communism in the former Soviet Union and Eastern Europe are every bit as bereft as were the victims of World War II in Europe and Japan. Yet Western governments are sponsoring no massive Marshall-like spending program to stimulate these economies.

As if to summarily banish all talk of deflation, optimistic economists in the U.S. point to the Consumer Price Index, rising at an annual rate of 2.7 percent as of October. But what if the CPI doesn't tell the real story? DKB's Braverman contends that perhaps 1 to 1.5 percent of the CPI represents "quality changes" — items like auto airbags that have been bolted onto existing goods to add new value — not true inflation.

Besides, he says, the CPI reflects the goods that Americans were buying 10 years ago — not the ones they buy today. There-

Salomon Brothers economist and market mover Henry Kaufman, a.k.a. Dr. Doom, cautions that a cyclical lift in the economy could more than double current inflation after 1995.

Deflation? Laugh at your own peril. It isn't conventional. But a serious case can and, for argument's sake, should be made that deflation and a depression, contained or otherwise, are already in progress.

Much of the world feels the pain far more palpably than does the U.S. Listen to Francis Scotland, editor of *The International Bank Credit Analyst* in Montreal: "We have a Molotov cocktail of deflationary economic conditions. In Germany wholesale prices are falling at an annual rate of 0.5 percent. In Japan wholesale prices are falling 3.7 percent a year. In Canada a study in late 1992 showed that the Consumer Price Index would be negative 4 percent if you stripped out all those items for which the government sets prices through regulation."

Cold comfort

Conditions have not changed much since then. Deflationary pressure is quite severe in the U.K. as well. "There is a price war among retailers," notes Stan Pearson, deputy global strategist at Scottish Widows Investment Management in Edinburgh, "and unemployment is still high at 10 percent."

Concludes chief U.S. economist Lacy Hunt of HSBC Holdings in New York, "Weakness has passed from one internation-

fore, as prices fall on computers, software, sneakers, airline tickets, hotel rooms, restaurant meals and financial services, the CPI takes too little note of the declines, if it reflects them at all.

Significantly, Braverman notes, the Producer Price Index, which anticipates the CPI, was essentially flat in 1993, even while the U.S. is ostensibly pulling out of recession ahead of the rest of the world. And from June through November, the PPI actually declined at a 2.4 percent annual rate (compared with a 2 percent gain in 1992), reflecting price cuts in finished goods like autos and clothing.

The pervasive anecdotal evidence of deflation, not captured by any statistics, affects attitudes, assert some economists. Consumer psychology is equally as potent an economic indicator as growth of the money supply. Across America bargains are about all that people will buy. Factory outlet malls and \$5 stores have taken root everywhere, killing off many conventional retailers. The cost of

the year ended last August. Braverman puts the true unemployment rate at about 10 percent. He counts all part-time, volunteer and marginally or self-employed workers who are considered fully employed by conventional unemployment measures.

Considering the lingering inflation psychology of Americans (not least economists), lower prices ought to be producing good cheer for a change. Instead, the Conference Board's consumer-confidence index has been at little more than half its highs, despite a spurt in November. Not a good sign, given that two thirds of the American economy is consumer-driven.

Consumers are spooked in part, says Parks, by the ever rising workforce cuts at high-visibility companies such as IBM; Eastman Kodak Co.; Sears, Roebuck and Co.; Warner-Lambert Co.; Philip Morris Cos.; AT&T; and Xerox Corp. They see their neighbors and friends as well as likable strangers on TV losing jobs, and they rein in spending. Parks reports, "The layoffs scheduled for the next 12 to 18 months

my company cuts costs, there are fewer people to buy my products. Cutting costs is contractionary. It doesn't help business or the economy until it's done." Says David Bostian, chief economist of Herzog Heine Geduld: "The theme of the '90s is that he who shrinks his balance sheet the fastest will win. It shocks me, but clearly there is a deflationary risk."

DKB's Braverman is more blunt. "You could say we have a deficiency of demand or that we have a surplus of workers," he observes. "But we have an imbalance that is going to get worse as we increase the emphasis on cutting costs and wages, on moving to part-time help and contract workers. The U.S., where layoffs have accelerated, had this idea to itself until recently, but now the Japanese and Europeans will begin doing everything as we have done."

Deflationary spiral

Taken too far, cost-cutting can become a prescription for disaster. Companies have attempted to produce goods at the low point along the cost curve, where average and marginal costs cross. When demand weakens, most companies avoid cutting output to try to maintain profits. That would shrink their cost advantage as they desperately try to maintain market share. Instead, says Braverman, they cut prices, wages and costs. He cites an American Management Association report showing that fewer than half the companies that have laid off 10 percent of their workers since 1988 have increased operating profits and less than a third have increased productivity.

Braverman worries, too, that new taxes and corporate health care costs, which in an inflationary environment could be passed along broadly to willing (or resigned) consumers, must now be spread more narrowly over individual companies' workers. Or companies may cope by slashing still more jobs. "This puts the U.S. and Europe into a deflationary spiral, pulling more and more industries into its maw," he says.

Such arguments would seem to be refuted by hard numbers. Deflation? How can that be when, for instance, U.S. housing sales rose 20.8 percent (seasonally adjusted) last September? Ah, says Braverman, those numbers are relative. Actual home sales were up only 1,000 units nationwide, to 58,000 units. Before the seasonal adjustment — which falsely builds in the kind of sales boom that followed the 1993 floods in the Midwest and the 1992 hurricane and rainstorms in the south and east — the increase in last year

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many staples has been dropping for months. The mood among even many of the rich is vaguely Depression-like: Who wants to be taken for a yuppie?

Sick economy

Everyday scenes in big cities recall the grim sepia photographs of the Great Depression. A recent head count of those who passed through homeless shelters found that an eye-popping 3 percent of the New York City and Philadelphia populations had been without a roof over their heads at some point in recent years. "Homelessness is emerging as a critical worldwide economic problem," says economic consultant Parks, who cites as a cause "the global decline in Germany, France, Russia, Eastern Europe, South America and the U.S."

U.S. unemployment — at 6.4 percent, officially, as of the end of November — is lower than Europe's. But the federal government now admits that the real number is at least 0.5 percent higher. The new measure, it seems, was more like 7.6 percent for

are ahead of layoffs in 1992 or even of layoffs during the recession of 1990 and 1991." By December U.S. companies had announced upwards of 450 planned cutbacks extending over more than 720,000 jobs, says Edward Hyman Jr. of International Strategy & Investment Group.

Never mind the 1 million new jobs created in the U.S. in 1993. This otherwise upbeat statistic ignores the not-so-happy news that the "recovery" has seen 700,000 fewer new jobs created than during the last business cycle. And the bulk of them have come in low-paying arenas like bars and restaurants, retailing, temporary services and nursing homes. "Since the nadir of the recession in March 1991, the old and new leading economic indicators both show growth far below that of previous recoveries," Parks says. "This is a very sick economy."

The alarm about corporate cost-cutting and layoffs is spreading. "One business' expenditure is someone else's revenues," notes Brian Wruble, president of Delaware Capital Management in Philadelphia. "If

was only 1.8 percent. Although U.S. housing starts grew 10.9 percent, to 1.4 million, in the first nine months of 1993, chimes in Delaware Capital's Wruble, this spectacular-looking total comes to less than two thirds the number of housing starts for all of 1972 — some growth.

A similar pattern emerges for cars, says HSBC's Hunt. Some 13.6 million cars and trucks rolled out of showrooms in the first ten months of last year, a substantial increase over 1992. Yet a large and increasing percentage of these "sales" were actually leases, says the economist, meaning that they increase the nation's already burdensome debt load, limiting the benefits of the increased consumption. Besides, Braverman notes, auto prices actually dropped by 4 percent last year — which will ultimately hurt the currently prospering automakers' bottom lines.

Corporate profits are in fact already under severe pressure — in the U.S., Europe and Japan. Earnings for 597 major U.S. companies rose a combined 24 per-

says Braverman. Unfortunately, most of the companies that are borrowing or raising equity capital were sick to begin with and are using the new money to strengthen their balance sheets or make their founders rich. Companies are using very little new equity capital to grow, according to Parks. "The official flow-of-funds statistics issued by the Federal Reserve unambiguously supports this fact," he says. And the equity markets have not replaced the bank credit that small and medium-size companies relied on in the past to create jobs.

One unexpected reason: Interest rates are in fact quite high. *Real* rates, says Robert Giordano, head of economic research at Goldman, Sachs & Co., "are still twice as high as the average in other recoveries. The weighted-average real rates are at 5 percent for the household sector and 4 percent for business, where the average in the last two cycles was 2 percent and 3 percent for households and businesses, respectively." Giordano does think the economy is growing, though

“M*any managers run in herds like buffalo, and they will be caught this time, too.”*

cent in the third quarter last year, compared with the like period in 1992. Although that represented a sharp increase from the 11 percent gain of the second quarter, the improvements came mostly from cost-cutting, not from any surge in revenues. How many times can industry pull that rabbit out of the hat? wonders Wruble. And for every industry that had far higher earnings than in 1992, there were nearly as many with earnings that fell just as sharply, according to *The Wall Street Journal*.

When cost-cutting will no longer do any good for hard-pressed companies, reason many industry leaders, low interest rates and the equity markets will ride to their rescue. "We have had an orderly deleveraging of the U.S. economy," notes Dreyfus economist Hoey. "This, along with the equity channel of monetary stimulation, has transformed Federal Reserve ease into cheap available money for troubled old companies like Chrysler and Equitable and Citicorp, and for reverse LBOs and expanding businesses."

Yet the accepted wisdom isn't working,

slowly, but he says that rates are not low enough to accelerate investment. Braverman goes further: Greenspan has cut banks' overnight "funds" rate to 3 percent, he says, but that's still too high relative to the current 2.7 percent CPI and, especially, to the 0.1 percent PPI.

Credit obstacles

Favorable interest rates may also be less of an investment driver than economic pundits pronounce them to be. What encourages new investment is not cheap credit at all, according to a new study of more than 5,000 U.S. manufacturing concerns from 1971 to 1990 by Steven Fazzari, an associate professor of economics at Washington University. His work shows that businesses base their investment decisions on the general health of the economy and their own sales and profit growth and cash flow. Says Fazzari: "With the bulk of investments, the effect of interest rates [whether high or low] is very hard to find. Weakness in the economy is more likely to reduce investment than lower

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interest rates are to stimulate it."

The state of the credit markets would tend to support Fazzari. "We are very busy issuing new loans," says Gary Ciminero, chief economist of Fleet Financial Group. "But older loans are getting paid down at the same time. Until businesses borrow and spend money to expand, the cuts in interest rates do nothing but cut the income of the people who

well-capitalized, U.S. banks must now have a minimum of 10 percent of their capital in equity. "This was the largest increase in capital requirements ever," he complains. "And bank regulators are using stringent measures to determine which banks are good. It's like shutting the barn door after the horses were stolen."

The signal to banks, at a time when the economy desperately needs easier

the max. And boy, are Americans, and America, leveraged. Total U.S. nonfinancial debt (the obligations of everyone except banks, insurance companies and other financial intermediaries) has fallen a tad, from 195 percent of GDP in 1991 to 192 percent last fall. But it's still horrifying.

Moreover, the improvement has come predominantly from corporate restructuring. And balance-sheet beautification programs, Hunt notes, have hampered many U.S. working stiff's efforts to clean up their own balance sheets. Add up all the credit card, mortgage and other personal installment debt, and the average American household owes a staggering 87 percent of its aftertax annual income — only a hair better than the 1989 high-water mark. That does include mortgage debt, but Americans' household debt, in real dollars, is roughly triple the 1947 level.

Total U.S. debt has reached a staggering 250 percent of gross domestic product, the highest it's been since the eve of the Great Depression. H. Ross Perot's rantings notwithstanding, federal debt today accounts for little more than a quarter of America's nonfinancial debt — down from nearly three quarters at the end of World War II.

Given all this leverage, the number of greenbacks pouring into the world's financial markets is a bit disconcerting. No one seems to know exactly where all that cash is coming from. But the Investment Company Institute has concluded that the bulk is not coming from bank certificates of deposit, as most people suppose. Clearly, some of the funds flowing into the markets are — you guessed it — borrowed. With U.S. brokerage houses like Merrill Lynch and Prudential Securities promoting or planning home mortgages backed by securities, it's no surprise that security loans account for 4 percent of U.S. borrowing, the highest level since 1973, says Braverman.

That probably has something to do with stock market price-earnings ratios worldwide being 50 percent higher than they have been at any time during the past 20 years. Sure, the markets expect higher earnings. But earnings forecasts have been propelled by the old inflationary groupthink. If the analysts' 15 and 20 percent average earnings gains do not materialize — and there is every reason to suspect they won't — the markets could be in for a hard fall. That's one reason Putnam Cos. chief economist Robert Goodman recommends long-term U.S. Treasuries and municipal bonds. Economist Parks agrees. "In plain English, even if earnings and dividends were

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hold the paper, dollar for dollar." Those cuts, he adds, have hit retirees — a key part of the consumer market — hard.

Lower interest rates *would* grease the economy's wheels if businesses were to decide to invest. But a host of impediments to borrowing remain, says Braverman. Not the least of these is bank regulators' post-S&L-crisis assault on declining capital ratios. To be considered

credit, is not to make loans that might in any way be construed as speculative. "The FDIC and Comptroller of the Currency are not disciplining banks that don't make loans in their communities," says Braverman. "Instead, they are rewarding them." In short, what good are lower rates if no one is able to borrow?

Low interest rates haven't boosted the U.S. housing market, either. "The Fed has reduced short-term interest rates to one quarter of what they were four years ago," says Fleet's Ciminero. "This has merely blunted the decline of real estate. Building values have stabilized, even in the worst markets, and the low rates have made housing very affordable. The problem now is to get people to commit."

Federal Reserve data shows that net funds raised by the entire private sector, including commercial and private mortgages, had fallen by more than half since the 1985 peak, to an annualized rate of \$245 billion by the second quarter of last year, notes economist Parks. "This constitutes a collapse in demand for credit, despite low interest rates," he says. Adds Braverman, "The rates of debt growth have been the slowest ever recorded."

U.S. investment is lagging. Spending on plants, machinery, office buildings and the like — that is, fixed investments — was less than 13 percent of GDP in 1992, down by more than a third since 1978. Says Delaware Capital's Wruble, "That's like having four recessions superimposed on one another." As 1993 closed, capital spending had not improved.

Another economic suppressant, paradoxically, is the level of debt already held by Americans. HSBC's Hunt notes that you can't borrow if you're already leveraged to

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to exceed the historical norms, stocks are overpriced now — by more than they were in 1929 or 1987,” he says. “Money managers run in herds like buffalo, and they will be caught this time, too.”

In his latest book, *A Short History of Financial Euphoria*, John Kenneth Galbraith notes ominously that leverage has been a common denominator of all market crazes since banks discovered they could print notes. Another point the dour economist makes: Market euphoria has a way of depriving people of good sense.

Hoovering

Right now policymakers are behaving as if they had a shortage of just that. If worldwide deflation is really — or potentially — a serious problem, then the worst thing governments can do is pay off their massive debts in a counterstimulative rush. “We got ourselves into overkill on deficits during the Reagan years,” says Nobel prize-winning Yale University economist James Tobin. “We got chronic deficits that we should not allow ourselves to have. But that doesn’t mean that we should get out of them in a hurry in an economy that is weak.”

Braverman echoes Tobin’s thinking. “George Soros says the world’s governments are dealing with the current situa-

tion as if John Maynard Keynes had never been born,” he says. “It’s as if the proper treatment for a burn victim was to give painkillers so he won’t go into shock, but the doctors are saying, ‘You’re addicted to painkillers. No more.’ So the patient dies.”

Wruble is even more emphatic. “Repeat after me,” he instructs. “The budget deficit is your friend.” No one likes the \$254 billion deficit, Wruble concedes. And the roughly 85 percent of the U.S. government budget that is made up of transfer payments to armed forces personnel, government workers, Social Security and Medicare recipients, as well as interest payments, would be better spent on investment in fixed capital to foster long-term growth. Yet those transfer payments, says Wruble, have kept money in the recipients’ pockets: “The deficit has prevented breadlines.”

Yet the idea that the deficit must be attacked aggressively grows stronger every day. Witness Harry Figgie Jr.’s bestselling book, *Bankruptcy 1995*, and Perot’s populist appeal, founded largely on the notion that government spending is bad. Former senator Warren Rudman’s deficit-bashing group, the Concord Coalition, has also gained ground.

Legislative memories are short. Washington has acted boldly to cut its deficit in the past — in the desperate

years immediately following the 1929 stock market crash. Democrats and Republicans alike agreed that the budget had to be balanced and the cost of government reduced by at least 25 percent. In 1929, as now, the greater fear was inflation. This endeavor prolonged the Great Depression. In Galbraith’s words, it “limited efforts to make interest rates low, credit plentiful and borrowing as easy as possible under the circumstances.”

History repeat itself? Never in quite the same way. A social safety net, frayed though it may be, acts as a check against the ravages of another Great Depression. It would also be comforting to think that politicians have learned the lesson of that era’s failed policies. Still, the central banks of Japan, the U.S. and Germany have all expressed concern of late about securities market and real estate speculation, and one way to control them would be to raise interest rates. “When one central bank expresses this view, it’s not important,” says Jonathan Francis, head of global strategy at Putnam. “When two central banks worry, it’s interesting. When three central banks say it, you had better not ignore them. Right now three central banks are talking about it.”

Perhaps someone should send the bankers a copy of Galbraith’s *The Great Crash*. ■

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