19851025

THE U.S. ECONOMY

The forest fire of disinflation

By John Rutledge

THE AMERICAN economy is out of control; at least, out of the Government's control. The disinflation which the Federal Reserve started in 1979 is now racing across the country like a forest fire. And although the Fed started it, it does not have the ability to call it back.

The textbooks tell us that when government officials pull the levers of economic policy, things are supposed to happen. Increasing budget deficits are supposed to stimulate demand, raise economic growth and push interest rates and inflation higher. Rapid money growth should produce more growth and more inflation. Congress has given us rising deficits, and the Fed has run the printing press around the clock for nearly a year. And yet inflation is *falling*, interest rates are *lower*, and economic growth has *slowed*. Does nobody out there read the textbooks? And if government policy makers are not in control, then who is?

I believe the U.S. economy has entered Phase II of the 1980s disinflation, and that it is now being powered more by the actions of private investors and managers than by government policy makers. In Phase I a tightening of Federal Reserve policy and the gradual break-up of Opec's monopoly grip on oil prices pushed inflation lower. Private investors and corporate managers, initially sceptical of the Government's commitment, did not take major steps to get in line with low inflation. But in Phase II, inflation has been low enough, for long enough, to indicate that it may be here to stay, and that is beginning to affect people's behaviour.

Investors and business executives are falling over each other in their new-found zeal to "restructure" for low inflation by selling their surplus fixed assets, repaying debts, repurchasing their own shares and trimming costs. These restructuring activities push the prices of fixed assets down, in order to clear the market of unwanted refineries, box cars, drill rigs and office buildings, and raise the prices of bonds and stocks to clear the market of excess demand for financial assets. And these price movements are wholly independent of current economic policy.

In Phase II, the course of inflation and interest rates is determined more by private restructuring activities than by policy impulses from the Government. In the same way that a diesel engine continues to run after you switch off the ignition, the momentum of Phase II restructuring will continue to push inflation and interest rates lower until restructuring activities are complete, regardless of near-term Fed policy.

Phase II deflation pressures are caused by the overleveraged condition of U.S. balance sheets. These receive little attention from most macroeconomic analysts who are fixed on national income accounts and other flows of funds. But balance sheets are crucial, if only because they are so large.

At the end of last year, the balance sheet of the U.S. economy contained more than $27 *trillion* in assets, as compared with last year's GNP of $3.8 trillion, savings of $156bn and budget deficit of $170bn. Of the $27 trillion, $12 trillion, or 44 per cent, was held in the form of *tangible assets* — properties, gold, used cars, etc — and the remaining $15 trillion was in equities, bonds, bank deposits or other *financial assets*. I believe that the proportion which investors choose to devote to tangible, as against financial assets, depending on the relative returns, is *the* key factor in determining the level of interest rates.

> The sharp drop in interest rates has been caused by the public's switch away from tangible assets in favour of holding securities

To conventional flow-of-funds analysts, real interest rates equate the demand for credit (government and corporate borrowing) with the supply from private savings. Not enough savings? Interest rates will rise to coax people into borrowing less and saving more. Too much savings? Interest rates will fall to discourage saving and encourage investment spending. This simple and compelling logic has pushed many corporate treasurers into early retirement since 1981, by making them prematurely issue long-term fixed-rate debt at exorbitant rates. In the past four years, despite rising deficits and a chorus of higher rate forecasts, interest rates have fallen sharply. Sometimes simple ideas are simply wrong.

As an alternative to the flow-of-funds logic I would suggest that the level of real interest rates depends on the demand of private investors for alternative assets, and that the sharp drop in interest rates since 1981 has been caused by a massive shift in the public's preferences away from holding tangible assets, and in favour of holding securities.

Major swings in inflation are the most important cause of the shift in asset demands. Private investors, like professional money managers, continually compare the yields on alternative assets, and attempt to shift funds from low-yield to high-yield assets to improve their future wealth. Since inflation is an approximate measure of the rate of return of tangible assets, swings in inflation can lead to large differences between the yield on tangible assets (inflation) and yields on financial assets (interest rates). This causes investors to attempt to convert some portion of their holdings from one category of asset to the other, which, in turn, leads to wholesale changes in asset prices.

In the 1970s, for example, rising inflation led investors to attempt to unload securities in favour of real estate, gold and collectibles. Of course, the fact that everyone *wanted* to turn their bonds into bungalows didn't make it happen, but it did affect their prices. Real values of equities and bonds fell sharply, interest rates rose, while properties, farmland and other hard assets soared in value. By 1980, investors had increased the tangible asset share of their portfolios from its 1973 level of 41 per cent to over 46 per cent, and U.S. corporations had restructured their balance sheets to live with inflation by going deeper into debt to buy oil reserves, refineries, timber, farmland and other fixed assets.

Most of the damage inflicted by the 1980s disinflation has been done to the balance sheets of corporations and households. Falling inflation depressed the return on holding tangible assets, in effect reversing the pattern of returns from the 1970s. Initially, investors were sceptical of the decline of inflation and stubbornly refused to liquidate their positions. But as interest cost on debts continued to mount, and asset values failed to grow, the capital positions of hard asset owners deteriorated. One by one investors made plans to sell their low-yield tangible assets, and to repay debts or purchase high-yield securities with the proceeds.

The results were twofold. First, the buyers' markets in tangible (hard) assets drove their prices down sharply, producing a wave of debt crises (eg Penn Square, Continental Illinois, Latin loans, farm loans) once investors discovered the collateral behind asset-based loans had evaporated. And shrinking net worth further increased the leverage of already-stretched balance sheets, leading to additional forced liquidations of fixed assets.

Second, the hard asset sell-off pushed interest rates steadily lower, both because debt crises and bank failures inject fear into the hearts of the Fed Board, causing it to loosen its grip on the money supply, and through the direct effects of private sector portfolio restructuring. In practice, an investor's decision to reduce his holdings of tangible assets is identical to a decision to increase his holdings of financial assets. When investors do so in the aggregate, the prices of tangible assets fall, and the prices of financial assets go up; ie, higher bond prices and lower interest rates.

My impression is that we have a long way to go before balance sheet restructuring has fully run its course. Most U.S. companies are still at the let's-take-a-look-at-it stage, where there is a lot of talk about asset sales, but the boss still shows up for work in his private jet. Even the early companies in the restructuring game have a lot more to do. The asset sales which have been already announced but not yet completed could take another one to two years. And the sales which are still to be announced will affect the markets even beyond then.

Indeed, it is clear that private transactions will continue to rival changes in government economic policies in determininging the trend of inflation and interest rates during the rest of the decade. My money is on the private economy winning this tug-of-war, and that both inflation and interest rates will continue to move lower as a result.

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