LAWSON KROEKER
INVESTMENT MANAGEMENT

As We See It

> "Economic ideas move in circles; stand in one place long enough and you will see the same old ideas come round again." - Sir Dennis Robertson
>
> British Economist

In *The Death of Inflation*, Roger Bootle, the London-based chief economist of Hongkong & Shanghai Banking Corporation, points out that, "Every generation of economic thinkers has a searing experience which colours attitudes for a lifetime." For example, the Great Depression of the 1930s influenced a generation of economic policy makers to focus on unemployment, while the resulting inflationary environment of the 1970s influenced today's policy makers to focus on inflation. The scourge of unemployment during the Great Depression was so prominent in the minds of legislators following World War II that it prompted the passage of the Employment Act by Congress in 1946. The act stated that it was the Federal Goverrunent's responsibility to "promote maximum employment, production and purchasing power." Obsessed with maintaining very low levels of unemployment during the 1950s and 1960s, actions were taken which eventually lead to inflation. "With the benefits of hindsight, they [policy makers] not only downplayed the seriousness of the inflation danger, but by the 1970s were aiming for levels of unemployment which were unrealistic in the changed circumstances of the time," states Bootle.

Today the possibility of deflation is far from policy makers' minds. Rather, the focus is on policies designed to avoid the inflation and instability of the 1970s. Mr. Bootle feels it is likely that since fighting inflation is so deeply ingrained in the minds of policy makers, ". . . it may well continue to dominate until a new generation, marked by a different searing experience, rises to take positions of power and influence in economic policy."

What might this *searing experience* be? Mr. Bootle and a few market observers are beginning to express concerns that we might be heading for deflation, in other words, actual price declines. Disinflation, the progressively lower rates of inflation we have experienced for the last 15 years, has provided a great envirorunent for the financial markets. Both bond and stock prices would likely decline if inflation were to reemerge. Whereas deflation could impact the two asset classes in opposite ways. Short periods of deflation would allow interest rates to fall which would be bullish for the economy and common stocks according to David Ranson, president of H. C. Wainwright & Co., in a recent *Wall Street journal* article. However, an extended period of deflation, while bullish for bonds, particularly those of high quality, would likely be detrimental to stocks as profitability would be eroded.

There are numerous signs that suggest inflation may not be the nemesis many view it to be. Excess capacity in many industries could lead to price cuts and deflation, as Jack Welch (Chairman of the global giant, General Electric) stated in a *Financial Times* article, "the challenge is that there is excess capacity in almost every industry." In a recent *Forbes* column, A. Gary Shilling, an independent economist, discussed some of the prevailing economic developments he considers deflationary. For example, defense spending which is highly inflationary has declined sharply with the end of the Cold War. Moreover, governments worldwide seek reduced spending and minimized deficits while their central banks stand ready to raise interest rates at the first sign of inflation. Today, to improve profits in an increasingly competitive global economy, many companies have been forced to reduce production costs through restructuring rather than risk losing customers by increasing prices. For the U.S., a strong dollar has curtailed exports and encouraged imports which further precludes domestic companies from raising prices.

So far, all of these deflationary trends have only resulted in the ideal environment of disinflation. Meanwhile, the prevailing view is that inflation (our last nemesis) is the dominate threat. That may well be the case, but the possibility of opposing outcomes evolving from deflation should not be ignored. Like generals preparing to fight the last war, today's policy makers may be looking at the wrong data. As Buckminster Fuller once said, "What seems to be important at the moment is never what is really going on.

October, 1997

450 Regency Parkway, Suite 410 | Omaha, Nebraska 68114-3701 | *tel* 402.392.2606 | *fax* 402.392.2597 | www.lawsonkroeker.com