Have the laws of economics been repealed ?

The U.S. remains the exception: the exuberance of its economy explained as the happy outcome of unique factors

by Jean-Jacques Rosa

Has the third industrial revolution, as it unfolds before us, done away with the usual limits to economic growth and stock valuations? One could well believe it in these times of the "new economy" with all the capitalization ratios defying even the most audacious earlier estimates. The growth of the U.S. economy, in its ninth year, belies all forecasts of turnarounds or mere downturns. It continues to steer clear of the inflationary pressures that usually emerge at the end of long periods of expansion. And despite the words of warning uttered now for several months, if not years, with Alan Greenspan in the forefront, the high-tech stocks continue to pulverize all known records in terms of earnings valuations : the rates of 25 or 30 times earnings of "traditional" Dow Jones companies, which financiers already considered unrealistic, have long been outgrown. We are now talking capitalization ratios of 50 to 100 times current earnings, with prices surging ahead, despite losses which increase as fast as sales.

With prices for the "old economy" companies practically stagnant in New York for around a year, the buying fever for high-tech stocks appears all the more characteristic of a "bubble".

As Paul Krugman puts it, this has all the hallmarks of a Ponzi scheme or a chain letter or kite-flying operation. It takes ever more buyers chasing after a shrinking range of shares to ramp up prices and provide sellers with the extraordinary gains that justify the mass purchases needed to support already way-out prices.

Everyone is betting on there being some optimist out there prepared to pay more tomorrow for what he overpaid today. It just needs the pace to slacken for the influx of new buyers to dry up and the balloon to start deflating. They will then all be falling over themselves to claw back what they still can. The panic buying we are now witnessing, with everyone trying to get in on the action they missed yesterday, could well turn into panic selling.

The trend is not irrational in the strict sense of the word, since it is a matter of taking advantage of the bull run pulling in speculation and feeding it back into the bull run. But it implies acceptance of higher and higher risk levels, which will end up materializing. This is actually the very definition of speculation, i.e. an operation where an individual deliberately increases the level of risk he commits to.

But these developments are no less surprising in macroeconomic terms. The increased pace of U.S. growth without any notable inflation seems to bury once and for all the estimates of potential expansion limited to 2 to 2.5%, as based on past trends. And the absence of serious inflationary pressures puts the Phillips curve – the inverse relation between unemployment and inflation – on hold. Unemployment continues to fall without inflation kicking in.

But ought we really to be turning our backs on conventional macroeconomic analysis? In the first place, let us note that neither Europe nor Japan escape the textbook constraining relations. In Europe, a monetary policy tailored to suit the needs of France and Germany has re-launched growth, but not without raising inflation slightly, bringing both countries off the slippery deflationary slope of 1998. And in the other Union countries with a more sustained rate of growth, like Spain, Ireland, Portugal and the Netherlands, inflation has picked up. All pretty par for the course. Phillips is still alive and well in Europe. But this goes for Japan too, where the recession is dragging on with a rise in unemployment and deflation. The correlation between employment and inflation continues to apply with negative growth.

The U.S. remains a special case. But one that can be construed in traditional terms as a supply shock shifting the Phillips curve along without doing away with it entirely. The oil shock in the seventies was a negative supply shock: it cut back the capacity for growth and employment while increasing the natural inflation rate. But what the U.S. is currently experiencing is a positive triple whammy in supply terms: firstly with the peace dividend cutting back on military expenditure after the implosion of the Soviet Union in the early nineties; then there was the blooming of the global economy with the advent of the newly industrialized countries increasing the world supply of standard manufactured goods and preventing prices rising in the most advanced countries which now import them rather than make them themselves; and lastly, two decades down the line, the IT revolution has finally delivered the long awaited advances in productivity.

These three major factors account for the way supply can suddenly accelerate to exceptional growth rates without triggering the usual inflationary pressures. But this fortunate conjunction of favorable factors does not supersede the fundamental principles of economics, any more than an eclipse brings about a change in celestial mechanics. On the contrary, eclipses confirm rather than deny Newtonian mechanics, though they don’t last. Exceptional conjunctions remain the exception.

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