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Scratching beneath the surface

Stresses and tensions continue to build behind a façade of seeming tranquility.

Slowly, one by one, the icons of the New Economy, if there ever was one outside of Wall Street's imagination, crumble. The gargantuan debts accumulated in the insane race to be the biggest player in the profitless tech world are coming home to roost. As default rates skyrocket, we are hard pressed to remember that we are in a boom. (In an accompanying piece, Neil Rackoff provides further ammunition for choosing US government index-linked securities, thus bypassing the coming credit collapse.)

Billions of dollars of ridiculously inflated equity values vanish in hours, and yet the truth has not sunk in so far: A properly functioning capitalist system will arbitrage away excess returns. Genuine growth rates of well in excess of 25%, 50%, and certainly 100% (where they are not suspect) can only last for very short periods of time – surely not enough to deserve multiples of 50 and 100 times earnings, let alone 50 to 100 times revenues.

Even when earnings appear genuine, they rarely are. Some of the extraordinary games being played with stock options by seemingly solid corporate citizens are a case in point. A recent study conducted by UBS economist Joseph Carson found that the volume of gains on employee stock options dwarfs the corporate grantors' annual profits. The net cost to buy back enough stock to offset these options for just six companies – Microsoft, Cisco Systems, Yahoo!, AOL, Sun Microsystems, and Broadcom – is more than 15 times what they earned collectively in the year. It's another way of saying that if options are indeed a nondeductible compensation expense, then high-tech profits are not real. Here, too, the chickens will come home to roost. As grantor corporations run out of cash to buy back these options, massive stock dilution will eat away whatever earnings gains are achieved, leaving stockholders holding the proverbial bag.

Just because it is an obvious Ponzi-like scheme, however, it does not mean that one cannot capitalize on it. Our colleague, Dr. Steve Hanke, provides a fascinating – and little known – historical glimpse of someone who made a fortune by focusing on the obvious.

Finally, there is Japan. A deflation that just won't go away, an economy that continues to stagnate. From a global vantage point, there is not much to worry about as long as the US economy booms along. But a hard landing for the US economy is not too far off, and then Japan's worsening crisis will matter. With his usual coherent and clear explication, Dr. Hanke outlines what Japan needs to do to get out of its present mess. In discussing what event(s) are likely to trigger an economic revival, he lays out an extremely useful blueprint for timing an investment in Japan's equity and real estate markets.

In this issue

Contributions by Albert D. Friedberg, Neil A. Rackoff, and Steve H. Hanke.

JAPAN

Japan's troubled economy

Steve H. Hanke

I last speculated about Japan's economy in our March 28, 2000, issue. Back then, the consensus on the Japanese economy and stock market was still quite bullish. I didn't jump on the bandwagon. Indeed, I argued that the economy would remain submerged, and my last sentence warned readers that "if you are tempted by Japan, there is a good chance that you will get your fingers burned." As it turned out, I was right on both counts. Correcting for the Japanese government's statistical shenanigans, the economy has been flat, and the stock market has shed about 20% of its value since I issued my warning.

Now we must revisit the world's second largest economy in more detail, particularly since most of the commentary remains, at best, half-baked. In what follows, I will attempt to deliver a more fully-baked cake and present some future scenarios.

During the 1978-86 period, money growth (M2 + CDs) averaged about 8% per year, real GDP grew at a steady rate of 4%-5%, and inflation was low. The Louvre Accord in 1987 changed all that. The Bank of Japan (BoJ), acting under that political agreement, stopped allowing capital inflows to appreciate the yen, in nominal terms. It accomplished this by purchasing dollars. This resulted in an acceleration in the yen money supply growth rate. Indeed, during the 1987-90 period, money growth accelerated to almost 12% per year. That spurt generated an investment-led GDP boom. It also threw Japan's asset bubble pump into high gear.

Once the Japanese authorities decided that the bubble was dangerously large, the BoJ threw monetary policy into reverse. By November 1992, money growth had slowed to –0.6% (from 8.5% in December 1990).

Since the BoJ popped the bubble, money growth has been anemic, because the BoJ has targeted interest rates and persistently set those overnight call rates too high to accommodate adequate money growth rates. What has occurred is easy to detect by applying a simple supply-demand analysis. As the economy contracted and deflationary forces kicked in, the demand for credit collapsed, and call rates were set too high to allow the market for the loanable funds in the system to clear. Consequently, even though the BoJ was lowering interest rates, it had to drain reserves persistently from the banking system, resulting in a money growth slowdown.

Today, with call rates set at near zero, the M2 + CD measure of money supply is growing at only 1.9% on a year-over-year basis. Not surprisingly, Japan is still in the grip of a nasty deflation, with both the CPI and WPI remaining in negative territory. As a result, the demand for cash remains strong, and cash hoarding is the order of the day, with cash accounting for about 93% of the monetary base. Therefore, even though the monetary base is growing at a much more robust rate (almost 6.5% year-over-year) than broad money, most of the base growth is accounted for by a strong demand for cash.

Before closing this broad overview of the Japanese economy during the 1990s – one dominated by a bursting asset bubble, inadequate money growth, very slow economic growth and deflation – it is worth mentioning that the decade ended with two negative shocks that added to Japan's economic woes. In the spring of 1997, Japan increased taxes, which further depressed domestic consumption. Those tax increases were followed by the Asian financial crises, which caused Japan's exports to fall for several quarters, an unusual event in postwar Japan. Needless to say, all this has badly shaken the Japanese confidence in their economy.

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Regardless of the particular problem being analyzed or the analytical apparatus used to diagnose it, confidence plays a critical role, particularly given the current state of affairs in Japan. Even though confidence is a bit elusive and largely unobservable, it is central to my diagnosis of and prognosis for Japan's economy.

Economists have long recognized the importance of confidence. Indeed, most economists find extremes hard to explain – either booms or busts – without reference to it. For example, the American economist Wesley Clair Mitchell (1874-1948) wove "business sentiment" into much of his pioneering work on business cycles. He was not alone.

Members of the Cambridge School of Economics, which was founded by Alfred Marshall (1842-1924), have all stressed that fluctuations in business confidence were the essence of the business cycle. As the Cambridge don John Maynard Keynes put it, "the state of confidence, as they term it, is a matter to which practical men pay the closest and most anxious attention." That is, of course, why Keynes put great stress on changes in confidence and how they affected consumption and investment patterns. Frederick Lavington (1881-1927), a Fellow of Emmanuel College and the most orthodox of the Cambridge economists, went even further in his 1922 book, *The Trade Cycle*. Lavington concluded that without a "tendency for confidence to pass into errors of optimism or pessimism," there would not be a business cycle.

Confidence enters into more modern discussions of business cycles, too. For example, Robert Lucas (1937-), a Nobel Laureate and member of the Chicago School of Economics, has developed rational expectations tools for economic analysis. These tools have allowed economists to analyze the confidence that people have in government policies, particularly with regard to the consistency and plausibility of those policies. For members of the Chicago School, the credibility of government policies is the major source of changes in confidence, and consequent causes of swings in the business cycle.

There are different analytical constructs of confidence and, of course, various measures for each. I will mention three. The first follows Keynes's *General Theory* (1936) and is measured by conducting surveys of sentiments held by businessmen and consumers. These survey metrics are then used in constructing forecasts of economic activity. In Japan, the Tankan surveys measure this type of confidence for businesses. At present, the Tankan surveys show that with the exception of large exporters who are doing well and are investing, businessmen are extremely pessimistic. Consequently, they are not investing or creating jobs.

Surveys of the all-important Japanese consumers (consumption accounts for 60% of Japan's GDP) also reveal a chronic level of gloom and doom. However, it is important to mention that Japan's index of consumer confidence, as measured by the Economic Planning Agency's surveys, has registered a slow, but consistent, upturn for the last three quarters. This said, consumption remains depressed, with chain store and department store sales, on a year-over-year basis, falling in June by -5% and -2.5%, respectively. That's not all. To put these figures into perspective, June's retail figures represent the 39th month in which year-over-year sales declined.

The second analytical construct of confidence is much more sophisticated and follows Lavington. It contains two elements. The first is similar to that of Keynes and is encapsulated in Keynes's famous phrase "animal spirits," or what is often termed "business sentiment." The second element is the degree of certainty with which businessmen hold their beliefs. High uncertainty yields a low level of confidence about any particular outcome. Although analytically distinct, these two elements interact. For example, if businessmen believe that there is little basis for predicting an outcome, the "animal spirits" factor carries more weight and dominates the overall level of confidence. Lavington's sophisticated theory of the trade cycle is also dynamic and contains a "multiplier" of confidence. Two miserable men, for example, are more miserable than either is separately. Lavington's theory, therefore, contains both cumulative and contagion effects. In the Japanese context, uncertainty is high, "animal spirits" are low, and the multiplier of confidence is negative. Not surprisingly, this is a deadly Lavingtonian cocktail.

The third analytical approach differs from the first two. Unlike Lavington, Lucas and the rational expectations crowd place great stress on government policy as a generator of swings in confidence. In particular, they believe it hinges on whether governments and their policies are viewed as being credible. This amounts to a perception about whether the various elements of a government's policy are logical and consistent. If government policies are viewed as being illogical and/or internally inconsistent, confidence suffers. On this criterion, the Japanese confidence is very low. Among other things, many Japanese cannot understand the campaign being waged by the BoJ Governor Masaru Hayami to increase interest rates and tighten monetary policy to stimulate the economy. I, too, am puzzled by this truly bizarre policy proposal.

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To appreciate just how the chronic level of confidence works its way into fiscal and monetary policies – the overall macroeconomic stance – let's take a closer look at the Japanese case. Since 1993, fiscal policy has been expansionary, and since 1998, the stimulus has been truly excessive. According to standard Keynesian theory, this should have been stimulative. But it was not. This makes me wonder about the competence of those – like the IMF's Deputy Director, Stanley Fischer – who, as recently as May 30, urged Japan to unleash yet another fiscal rescue package to stimulate its moribund economy. It also leads me to ask, What's wrong with the standard Keynesian theory? After all, Keynesian orthodoxy asserts that a fiscal expansion, working through a positive multiplier, will stimulate an economy by even more than the fiscal injection.

Keynesian fiscal theory works as advertised when the fiscal deficits as a percent of GDP are relatively low (3%-4% or less) and the level of national debt is also relatively low (40% or less). When fiscal deficits and debt levels are relatively high, as they are in Japan, the fiscal multipliers become negative. As I have pointed out in previous issues of *FC&CC*, this empirical fact results because with relatively high deficits and debt levels, confidence takes a beating. Consequently, people increase the desired levels of real cash balances they wish to hold. This means that they hoard cash rather than investing or consuming, causing the sign of the fiscal multipliers to change from positive to negative. When this occurs, a fiscal expansion actually acts to dampen economic activity. Based on this diagnosis, my prognosis has been that Japanese fiscal pump-priming has acted and will continue to act as a drag on the economy.

My views on the futility of fiscal pump-priming in Japan are reinforced by Milton Friedman's empirical work on the effects of fiscal and monetary policies. He has shown that in the rare cases when fiscal and monetary policies are moving in opposite directions, monetary policy dominates. With Japan's super-tight monetary policy and ultra-loose fiscal policy, Friedman's work suggests that the overall macroeconomic stance is tight, and that it will tend to subdue economic activity.

Let's diagnose the monetary side of the coin in more detail. Many argue that the BoJ is already setting interest rates near zero, and, therefore, monetary policy cannot be loosened. This is utter nonsense. The BoJ could purchase Japanese government bonds (JGBs) and expand the monetary base, as it did in anticipation of Y2K. The BoJ claims that it doesn't want to do this now, because aggressive purchases of JGBs would undermine the quality of its balance sheet. This is rather strange, because it implies that the BoJ would rather have the private sector, namely the banks, undermine their balance sheets by purchasing JGBs. In any case, as John Greenwood has pointed out, the BoJ should not be in the business of maintaining a triple-A balance sheet or making a profit. The job of the BoJ should be to maintain liquidity and an appropriate price level to ensure real growth with stable, not falling, prices.

The BoJ could also expand the monetary base by purchasing foreign exchange, as it did after the Louvre Accord. The rub here is the Ministry of Finance (MoF). The MoF, which is responsible for the nominal yen exchange rate, wants to keep the yen-dollar rate between 100 and 115. An aggressive dollar purchase program, with the objective of increasing the monetary base, would, of course, result in a much weaker yen vis à vis the dollar.

Owing to preferences of the BoJ and MoF, Japan's monetary policy is in a trap, a policy trap. Unless Japan can extricate itself, that policy trap will keep it on a deflationary course. This, however, doesn't imply that the economy will remain in a slump. Here's how the process works, using a static analysis. With falling prices, real cash balances grow and eventually reach desired levels. When that point is reached, people start consuming and investing in assets that are priced at "low," attractive levels. Through this deflationary process, which works to increase real balances, the economy will eventually kick in and start to grow in real terms. Allan Meltzer recently presented a paper to the BoJ that shows exactly how this adjustment process works and how it ultimately helped to turn things around during the US deflations of 1920-21, 1937-38, and 1948-49.

Things aren't always that simple, however. The length of time required for deflationary forces to work on real balances and to put the economy back on its potential real growth path can be attenuated. This can occur if confidence keeps falling because of the collateral damage caused by the deflation – bankruptcies, eroded asset values, consequent problems with bank profits and balances sheets, etc. If confidence deteriorates, then the desired level of real cash balances keeps increasing and the gap between desired and actual cash balances is not closed. As a result, people continue to pile up cash hoards and don't start consuming or investing. Consequently, the economy fails to pick up steam.

It appears that this vicious cycle scenario has been occurring in Japan. The ratio of cash holdings (M2 + CDs) to nominal GDP, the so-called Cambridge K (the reciprocal of money velocity), continues to rise. Indeed, it is at an all-time high. Moreover, the Cambridge K's recent rise is unusual, because it is more the result of a decline in nominal GDP than an increase in nominal money. One obvious and direct way to overcome this gap problem is for the BoJ to ensure that the nominal money supply (M2 + CDs) increases from 1.9% per annum to 7%-8%. This would allow the gap between desired and actual cash balances to close rapidly and put a stop to cash hoarding. The problem here is the monetary policy trap that is imposed on Japan by the BoJ and the MoF.

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Unless something is done to increase confidence dramatically, Japan will remain in the grip of a nasty deflation. At best, it will take some time for the deflationary forces to close the gap between desired and actual cash balances. At worst, the adjustment process could deteriorate into a more profound vicious cycle that would attenuate the adjustment period. Under either of these scenarios, we must wait until the gap between desired and actual cash balances is closed, before the Japanese economy takes off. That will be frustrating, because we cannot observe the cash balance gap, and we can only indirectly measure confidence, which determines, in part, the desired level of real cash balances.

The only way that the adjustment process will come to a rapid conclusion is if policies are put in place that would narrow the gap between desired and actual cash balances. To accomplish this gap-closing and avoid a more pronounced vicious cycle, those policy changes must be dramatic and rapid. Below is a menu of policies, which are not necessarily mutually exclusive. They would do the trick, if implemented dramatically and rapidly. We should keep our eye out for them.

- The Keynesians could withdraw and allow the fiscal authorities to reduce undesirable, low-return government spending. Reduced government borrowing would increase the volume of funds available to the private sector. This "crowding in" process would enable the private sector to adjust its balance sheets more rapidly, boost confidence, and reduce the desired level of real cash balances.
- The BoJ could stop worrying about the quality of its balance sheet and aggressively purchase JGBs or other yen-denominated instruments. This would fill the cash balance gap with liquidity and jump-start the economy.
- Following the recent bankruptcies of the Sogo department store chain and the Seiyo property group, the government could pull the plug on the rest of the walking dead and let them go to the wall. This would allow asset prices to fall rapidly (goods and service prices would also fall), increasing real balances and providing the Japanese (and foreigners) with attractively priced investments.

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Unfortunately, it is unlikely that the Japanese will place an order from this menu any time soon. The Japanese are ultra-consensual and move slowly by nature. Moreover, the current coalition government is probably a short-term affair. Consequently, it isn't in a strong position to make a rapid, big move. This means that before we see brighter days in Japan, we will probably continue to agonize as we watch the painfully slow-moving deflationary adjustment process do its work.

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INFLATION WATCH

Will the 'real' real rates please stand up – or why TIPS are still a great buy

Neil A. Rackoff

We are puzzled about what accounts for the difference in yield between the real rate yield currently available on the 30-year TIPS Treasury Inflation Protected Securities) versus the implied rate available on the nominal yield (combination of real interest rate and expected rate of inflation) 30-year bond issue.

As a quick review, the value of the principal of TIPS is adjusted for inflation each day using changes in the Consumer Price Index for All Urban Consumers (CPI-U), hereafter called the "Headline" CPI. It stood recently at 3.70%. The Bureau of Labor Statistics publishes the index. Every six months a fixed-rate coupon is issued, with payment based on the revised principal amount. In other words, the securities protect an investor's purchasing power, because their coupon and principal payments will be adjusted to compensate for changes in inflation.

The conundrum is this: As of July 25, 2000, the real yield on the 30-year TIPS was 3.861%. Using the Bloomberg-calculated inflation assumption, we get a total yield to maturity of 6.954%. The nominal 30-year bond, however, is priced to yield 5.809%. If you subtract the real yield of the TIPS (3.861%) from the yield on the nominal bond, you arrive at a broader inflation assumption of just 1.948% for the next 30 years. Could this be right? Is the market forecast of 1.948% inflation correct, given the current rate of CPI-U (3.70%), or is there perhaps a mispricing of real rates (TIPS)?

If you are Federal Reserve Board Chairman Alan Greenspan, you might suggest that the inflation expectations implied in our calculation above seem to be (somewhat) in line with inflation numbers calculated by what is known as the "core rate" CPI (excludes food and energy prices), which had a reading of 2.40% as of June 30, 2000, as opposed to the Headline CPI of 3.7% (the highest reading since August of 1991).

However, we detect that even Chairman Greenspan is somewhat concerned that the current implied rate of inflation on the nominal bonds of 1.948% inaccurately reflects where inflation truly is. A clue lies in the following excerpt from his testimony before the Senate Committee on Banking, Housing, and Urban Affairs on July 20, 2000, in which he felt the need to explain that core inflation has risen from the indirect effects of energy prices:

"[As] I have already noted, to date, costs have been held in check by productivity gains. But at the same time, inflation has picked up – even the core measures that do not include energy prices directly. Higher rates of core inflation may mostly reflect the indirect effects of energy prices, but the Federal Reserve will need to be alert to the risks that high levels of resource utilization may put upward pressure on inflation.

"Moreover, energy prices may pose a challenge to containing inflation. Energy price changes represent a one-time shift in a set of important prices, but by themselves generally cannot drive an ongoing inflation process. The key to whether such a process could get under way is inflation expectations. To date, survey evidence, as well as readings from the Treasury's inflation-indexed securities, suggests that households and investors do not view the current energy price surge as affecting longer-term inflation. But any deterioration in such expectations would pose a risk to the economic outlook."

Let's assume for the moment, though, that the core rate referred to by Chairman Greenspan is the true measure of inflation and that nominal rates, as defined above, are the broadest measure of market expectations. Therefore, taking nominal rates of 5.809% and subtracting the 2.40% core rate gives us a real rate of 3.409%.

As we mentioned above, the real rate as indicated by the TIPS is 3.861%. It follows, therefore, that using the Fed's metric (core CPI), real rates should be lower than are indicated by the TIPS, thereby making them undervalued by 8.60%.

Now let's take a closer look at Fed Chairman's statement again. He makes a point of saying that *"energy prices may pose a challenge to containing inflation. Energy price changes represent a one-time shift in a set of important prices, but by themselves generally cannot drive an ongoing inflation process. The key to whether such a process could get under way is inflation expectations."*

In our opinion, he is pointing out a fundamental issue with inflation. Inflation does not happen in a vacuum and is always a monetary phenomenon. In other words, when the price of a component like energy rises, it won't affect the general level of prices as long as we are on a fixed budget. In fact, other prices would even fall as the demand diminishes, because again there is only a fixed amount of resources (money) available to purchase them. Inflation, therefore, would not rise, and the Fed would have nothing to worry about.

But that is not what has been happening. Core inflation has been rising. In fact, the CRB index is up 22% since March 1999. In other words, there has been no compensating drop in the general level of prices to offset the rising cost of energy, not to mention the fact that nontradable aspects of CPI, like housing and services, have been rising (try buying a house in the New York Metro area today!). This, according to the mathematics of inflation, is because (as the Fed knows and has accommodated) the supply of money as indicated by M3 (see Chart 1), despite having slowed somewhat in 1999, has picked up again in 2000. But which CPI number is heading in which direction? Is the Headline CPI number moving down or is the core rate moving up? It seems to us that, if anything, the core rate is headed towards the Headline rate, not away from it.

So back to our exercise. If we take the 30-year nominal rate of 5.809% and now subtract the Headline number of 3.70%, we get a real rate of 2.109%. Plugging that number into our little thesis makes the TIPS 37.50% undervalued!

The Fed however does not see things this way. It is comfortable that the real rate, as indicated by the TIPS, must be the "real" real rate and therefore *"to date, survey evidence, as well as readings from the Treasury's inflation-indexed securities, suggests that households and investors do not view the current energy price surge as affecting longer-term inflation."*

With all due respect, we think the evidence suggests that the logic is backwards. Even the Fed has to admit the TIPS are mispriced; otherwise, real yields as implied by the nominal bond would be equal, at the very least, to the core rate.

But in all fairness, we still need to suggest a reason why TIPS are pricing high real rates to complete our argument. Perhaps the most logical reason is that the TIPS are a relatively new instrument and represent only about 4.7% of total US Treasury debt. They thus do not generate a lot of interest among individuals and portfolio managers from an asset allocation standpoint and are therefore not properly reflecting the true level of real rates. It is interesting to note, however, that despite the fact the US government is curtailing the level of overall debt, it is increasing its issuance of TIPS across the yield curve. People will take notice and start to price in the evidence.

Needless to say, given this line of thinking, we continue to believe TIPS are a compelling investment.

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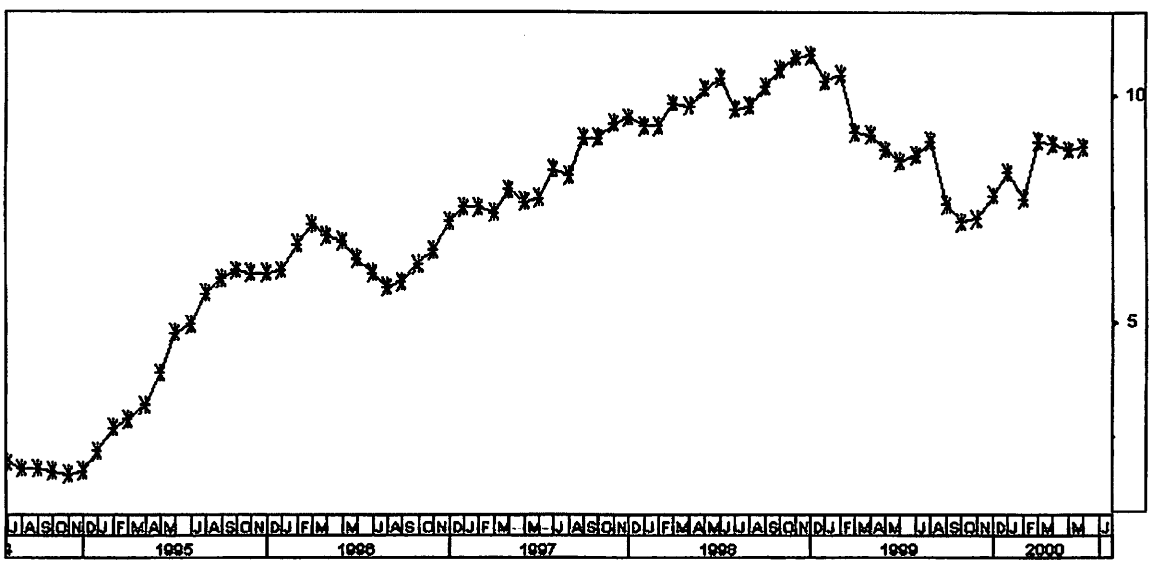
Chart 1 – M3% YOY



INFLATION WATCH

A lesson from the master, Richard Cantillon

Steve H. Hanke

Richard Cantillon, unlike David Ricardo and John Maynard Keynes, is not a household name. I have always found this puzzling, because all three had a great deal in common. They were sophisticated financiers who made (and lost) fortunes, and all were first-rank economists who turned their experiences into theoretical models. Ricardo's was a supply-side model; Keynes's was a demand-side model; Cantillon's was both. Furthermore, Cantillon's (1680?-1734) treatise, *Essay on the Nature of Trade in General* (1755) predated both Ricardo and Keynes. Indeed, it predated Adam Smith's *Wealth of Nations* (1776). I have, therefore, always argued that Cantillon, not Smith, was the father of modern economics.

All three made their fortunes by ignoring crowds and steadfastly focusing on what they deemed to be obvious. They were, in modern parlance, insightful contrarians who were capable of getting ahead of the curve.

Cantillon's speculations surrounding the famous Mississippi bubble are largely unknown and worth recounting. The Mississippi bubble was associated with a financial innovation, namely the debt-for-equity swap. The Mississippi Company was created to throw off the burden of France's mountain of high-yielding government debt. This was accomplished by converting it into junk equity. John Law, the brains behind the Mississippi Company, was therefore a financial innovator, an early incarnation of Michael Milken.

In 1717, Law was given permission to establish what was popularly known as the Mississippi Company. It had trading rights over French Louisiana. By a series of takeovers and mergers, it became a giant holding company controlling all French colonial trading companies. In the autumn of 1719 the company issued a large number of equity shares in exchange for the French national debt. By January 1720, shares that had traded for 160 French livres in 1717 had reached a price of 10,000 livres. However, Law, an advocate of fiat money, pushed the system too far and too fast. By monetizing the company's shares with a guarantee to convert them into bank notes at 9,000 livres each, Law created a financial sector that was totally out of line with the real economy. Consequently, the share price collapsed during the summer of 1720.

Richard Cantillon succeeded in making two separate fortunes out of the Mississippi System. The first was made on the rising market for Mississippi Company shares. Cantillon saw the potential earning power of the monopoly trading rights granted to the Mississippi Company. He took a large position early. His second fortune was made on exchange-rate speculation. Cantillon knew that French livres were not backed by hard specie. He also understood that the monetization of the Mississippi shares would result in a surge in the money supply and a sharp fall in the value of the French currency against British sterling. Accordingly, when the money pump began to work overtime to support share prices, Cantillon dumped his Mississippi Company shares, sold French livres, and bought sterling.

Although there are many lessons to be drawn from Cantillon, one is worth repeating. After the fact, it is clear that he saw the obvious before anyone else, took appropriate action, and did so while everyone else was riding a different horse.

This brings me to the consensus view of inflation in the US. Inflation forecasting is confusing, because so many claim so much with so many different forecasting models. Fortunately, Stephen G. Cecchetti and his colleagues at the Federal Reserve Bank of New York have conducted extensive research on all this. They have looked at three broad categories of inflation indicators: commodity prices (for example, specific prices for oil and precious metals and indexes for groups of commodities); financial indicators (for example, exchange rates, monetary aggregates and the term structure of interest rates); and real economic indicators (for example, capacity utilization and unemployment rates). In all, they employed 19 different inflation indicators in a variety of combinations to see which combination provides the best inflation forecasts.

Cecchetti and his colleagues conclude that the most reliable indicator of future inflation is changes in past inflation. Indeed, the inclusion of the 19 other indicators, individually or in various combinations, contaminates simple forecasts based on changes in past inflation. Accordingly, the use of any of the 19 other indicators results in inflation forecasts that are unsystematically either better or worse than the simple forecasts, depending on the time period studied. The problem, therefore, is that a forecaster doesn't know beforehand whether the inclusion of other indicators will improve his inflation forecast or make it worse. Since 1992, for example, the inclusion of other indicators would have produced less accurate forecasts than a simple model based on changes in past inflation. When forecasting inflation, the obvious conclusion is that the "trend is your friend."

Armed with these sophisticated statistical findings, we should, therefore, focus on inflation trends, if we want the most accurate guide for the future. At present, the consensus view maintains that inflation is not a problem. That conclusion is based for the most part on core inflation data (CPI minus food and energy). By this measure inflation is "low," with the year-over-year (YOY) June inflation rate at 2.4%. However, you should beware. Even the core inflation data contain a small upward trend. In June 1999, the YOY rate was only 1.9%. If we look at the YOY CPI, the picture is quite different. The June figure is 3.7%, a much higher rate than the core rate. More importantly, there is a dramatic, clear upward trend in the CPI data. The October 1998 YOY rate was only 1.4%.

This brings me back to the lesson from Cantillon. Don't ignore the obvious. There is an obvious inflation buildup in the system. Also, for inflation-indexed securities (TIPS) investors, the relevant (and obvious) inflation gauge to watch is the CPI. After all, the TIPS are indexed to the CPI, not core inflation. Fortunately for TIPS investors, the obvious has not yet been priced into the market.

OBSERVER

Is the BIS Austrian?

Steve H. Hanke

While the Bank for International Settlements (BIS), the central bankers' bank in Basel, doesn't advertise as an abode for the Austrian School of Economics, I detect that Austrian economics has crept into the BIS analyses. Confirming evidence is contained in the BIS Working Paper, "What Have We Learned From Recent Financial Crises and Policy Responses?" (No. 84, January 2000) by William R. White, head of the BIS's Monetary and Economics Department, formerly the head of research at the Bank of Canada. White's bibliography even contains a reference to a rock-solid Austrian book co-authored by one of my former professors, Fred Glahe, *The Hayek-Keynes Debate: Lessons for Currrent Business Cycle Research* (1999). The BIS Annual Reports of 1999 and 2000 also contain strong doses of orthodox Austrian analysis. All this is important, because it sheds light on the policy responses we might expect from central bankers.

The Austrian theory of the business cycle holds that by keeping the market rate of interest below the natural rate – the rate that would hold the rate of real investment down to the rate of voluntary savings – the banking system is able to initiate a cumulative movement away from equilibrium. In short, the unnatural expansion of the credit superstructure, which is caused by inappropriate central bank policy, overstimulates and distorts investment. The resulting asset bubble is unsustainable and must inevitably pop, because banks or other suppliers of credit find it impossible or too risky to continue to expand credit, or because investors find it too risky to go on borrowing and investing. To restore an economy to equilibrium, the Austrians' counsel is straightforward: Stand back and let the bubble pop, allowing for a rapid adjustment of the system.

So much for the theory. What has the BIS said? In the 1999 Annual Report (pp. 5-6), the BIS concludes that the Asian crisis was the result of nothing more than a classical Austrian boom-bust cycle. There was overinvestment during the boom phase, a necessity for a retrenchment later, and the usual problems associated with declining asset values and unchanged nominal liabilities. This year's BIS Annual report contains more of the same (Chapter VI). Great stress is placed on the fact that risks are underpriced. The BIS also concludes that equity valuations are currently based on very (if not wildly) optimistic assumptions about prospective earnings growth rates, are unusually high, and are vulnerable to sharp correction. As the BIS puts its, "any misallocation of capital during the expansionary period also implies the need for subsequent adjustment." This is pure Austrian logic.

The policy implications based on this Austrian logic are noteworthy. The BIS counsels central bankers not to target asset prices. It favors setting monetary policy to deliver stable prices for tradeable goods and services. But what should they do if an asset bubble appears? Here the BIS hedges its bets. That said, a paper delivered by the BIS's William White at the Bank of Japan in early July is revealing. He states that there are two options: "On the one hand, it is tempting to say that a bubble should be burst as soon as one knows it is a bubble. On the other hand, since such certainty will come only very late in the day, a cynic might feel a better course would be for policymakers to stay out of the way and simply let nature take its course."

The fact that Austrian economics has entered the central bankers' citadel has important implications. To appear in a BIS Annual Report implies that the central bankers have signed off on Austrian themes. For investors, this means that the central bankers realize that there is a moral hazard associated with underwriting stock market valuations. Consequently, those who believe the Fed has written an out-of-the money put on the US stock market are playing with fire. Indeed, they are assuming much more risk than they realize.

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