
**DEFLATION GURU DR. A. GARY SHILLING BELIEVES THAT BPO WILL HELP "GOOD" DEFLATION BUT WARNS OF AN ANTI-IMMIGRATION TREND IN THE U.S.**

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*In an exclusive interview, his first to an Indian publication,* ***Dr. A. Gary Shilling,*** *considered as the international guru of understanding deflationary forces, spoke to* ***Prof. Amita Shankar,*** *in New Jersey, U.S.A.* ***Prof. Amita*** *is Associate Dean, Prin. L.N. Welingkar Institute of Management Development & Research.*

*Dr. Shilling is President of A. Gary Shilling & Company, economic consultants and economic advisors. A regular columnist for Forbes magazine, he is well known for his forecasting records. In the spring of 1969 he was among the few who correctly saw a recession would start late in the year. In 1973 he stood almost alone in forecasting that the world was entering a massive inventory-building spree to be followed by the first major worldwide recession since the 1930s. He is widely credited with being the first to predict the onset of deflation in his 1998 book "Deflation".*

*Dr. Shilling received his M.A. and PhD. in economics at Stanford University. He set up the economics department at Merrill Lynch, Pierce, Fenner & Smith at age 29 and served as its first chief economist. The text of the interview is given below.*

### *What is deflation?*

Shilling: Deflation simply means that you have more supply than demand so prices in general tend to decline. The U.S. economy is right on the edge of it now. Prices for goods are flat or declining, especially for some services, such as telecommunications and airline travel. Deflation does not mean that each and every price declines. But, on average, as measured by major indices, prices tend to decline. In the U.S. while prices of services such as health care and education are going up, we have falling prices for broad indices like the Purchasing Price Index. (The Producer Price Index (PPI) program measures the average changes over time in the selling prices received by domestic producers for their output. This index decreased 0.3 percent in May and 1.9 percent in April 2003).

Deflation is different from disinflation-declining but positive rates of overall price change.

### *Is deflation good or bad?*

Shilling: To many, the mere word "deflation" conjures up the financial collapse of the 1930s. That is what we call "bad" deflation. We experienced it in the Great Depression and Japan is experiencing it now.

Good deflation, by contrast, is what we had in the late 1800s or the 1920s, and again at present. It is led by a rapid technological advances and vast increases in supply. With technology and capital now free to move around the globe in search of the most cost-effective locations, the West is exporting the Industrial Revolution to the developing countries and is importing the resulting low-cost output. It looks like good deflation not bad. It has not occurred with a 1930s-style financial collapse, which severely depressed incomes and demand.

Could you elaborate on good deflation? Most people, including Federal Reserve Chairman Alan Greenspan, say that it could have extremely harmful consequences.

Shilling: Deflation isn't as new, strange, rare, or exotic as many believe. We have experienced it between 1839-1843 and again in the 1920s. These periods saw a burst of technology, which gave a huge burst of productivity and supply, plunging prices down.

At the end of the Civil War (), U.S. moved into the American Industrial Revolution. Industrial growth was spurred, of course, by the needs of the Civil War, but after the war, the boom continued, fueled by rapidly changing industrial technology and rapidly expanding railroads, which provided an increasing market potential. The number of patents granted in the nation grew from 25,200 in the 1850s decade to 234,956 between 1890 and 1900. Largely because of mechanization, output per farm worker in wheat, corn and oats increased three to four times between 1840 and 1910, or at compound annual rates of 1.5% to 2.0%. Overall, US productivity after the Civil War grew at a sustained rate unequaled at any other period of history. Real GNP grew 4.3% per year, about twice today's growth rate.

The availability of so much output produced at such lower costs depressed prices considerably-even though the reduced prices vastly expanded sales, and ordinary Americans could afford to eat better and buy manufactured goods for the first time ever. The overall Wholesale Price Index dropped 49.7% between 1870 and 1896 or at a 2.6% annual rate. Between 1866 and 1897, the charge for carrying wheat from Chicago to New York fell from 65 cents per 100 pounds to 20 cents, or a 70 % decline. So even though deflation was the order of the day after the Civil War, excess supply was the cause, not declining demand.

The "Roaring '20s" were also a time of deflation driven by supply growing faster than demand. New technologies especially electricity, were responsible for much of the boom. Electrification of factory power equipment grew from 33% in 1914 to 74% in 1929. Construction also took off during the 1920s.

Of course, the granddaddy of all boom industries during the 1920s was the automobile. Henry Ford's application of interchangeable parts and his introduction of the moving assembly line increased the production of cars by the whole industry from 65,000 in 1908 to 1,000,000 in 1915. Between 1913 and 1914, the labor time required to put together a Model T chassis dropped from 2 hours and 38 minutes (down from an original 12 hours and 28 minutes) to 1 hour and 33 minutes. Consequently, the price of the Model T dropped from $500 in 1913 to $260 in December 1924.

***So, what we are seeing today is good deflation?***

Shilling: Yes, unless in the unlikely event of a U.S. financial crisis, things will go to hell like in a bad deflation. Japan is suffering the bad kind, touched off at the beginning of the decade by severe financial problems. Japanese stocks fell 58% in the 1990-1997 years. In Switzerland, where the financial structure remained sound, it's been good deflation with stocks rising 270% in the same years.

Our long-term outlook for the next decade is good deflation. This will be the result of big exports from developing countries and competitive devaluations. Adding to this downward shift in prices are international and domestic deregulation in developed countries, leaping mass distribution, growing use of internet, rapid technological advances and restructuring, as well as shift of important economies like China to market status.

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***How important is Japanese recovery to revive the world economy?***

Shilling: Before the rise of China in the last 3-4 years, there was a lot of feeling that Japan really needed to recover to sustain demand in Asia. But now you don't hear much of that. Now people have accepted that Japan is in some kind of long-term backwash and are much more looking at China as an engine in the area.

Having said that, Chinese exports are a great strength for that country, but also a potential weakness. We expect that the U.S. trade deficit will contract. This will squeeze the exports of foreign producers, including China. China does have immense potential for sustained rapid growth, but needs those big gains to accommodate the unstoppable movement of farmers to the cities, to keep urban unemployment in check, to clean up busted banks and restructure state-owned enterprises, and to fund social services including retirement accounts. China's reliance on rapid export growth and rising government deficit financing to achieve her needed economic growth is probably unsustainable.

***What are the options available to tackle deflationary pressure because of ageing population experienced by almost all countries in the developed world?***

Shilling: The real trick for this is basically to increase supply side enough, the productivity of those who will be working when the ageing populations retire. Those who will be working when the ageing populations retire, will produce enough not only for themselves but also for the retirees without getting into an inter-generation warfare as how they are going to split up a pie that is not adequate to satisfy demand of both groups.

I do think, but also, there will have to be increase in retirement age and probably some diminution in retirement benefits.

Japan has the biggest ageing population problem but it has a solution. It is running such a current account deficits for so many years that it has a huge pile of foreign assets. It can simply liquidate the foreign assets and buy imports to satisfy the demands of its retirees without in effect taking away from those that are still working. They are the only country in that unique situation; U.S. is in the opposite side.

### What will be impact of these trends on the unemployment numbers?

Shilling: My analysis is that with productivity growth we are going to have chronically high unemployment. And if consumers actually do continue what in the last couple of years is a savings spree (U.S. savings rate has been increasing for the first time in 20 years) that itself knock a percentage off GDP growth and that could give you a situation, my numbers are: you have 2.5 percent productivity growth and if the economy would otherwise be growing at a 3.5 percent in terms of demand but the switch from borrowing and spending to saving knocks a percentage of GDP growth you have 2.5 percent productivity growth and 2.5 percent GDP growth that means you have zero growth in labor force. That would be a tough situation. I do not know how it is going to work out. But of the things that we will probably see in this atmosphere is much tougher attitude to immigration in this country. That has been a great source of demand and a lot of people say that is one of the ways out of the post-war baby boomers dilemma. You simply rely on immigrants who are younger, working contributing to social security and contributing to the post-war babies who are retiring. But I suspect we are going to see much more in way of limitations on immigration.

### What is the impact of Business Process Outsourcing (BPO) on world deflationary trends?

Shilling: BPO has a positive impact on productivity. It is more a supply increasing side of the ledger than the reducing demand side. Sure to the extent that high paid jobs move from Detroit to Mumbai you are going to see diminution of big incomes of the United Auto Worker members in Detroit that constricts incomes and demand, but I would think that on a global basis it is more of an increase in supply because of bringing developing countries like India, South Korea and China into the market.

You also talk about the diminishing power of labor unions in your book.

Union power is coming down. One of the effects of globalization is that you simply cannot have strong unions at high pay levels, if there is not enough productivity offset to make them competitive on a global basis.

Germany is experiencing a weak economy, very close to bad deflation. Among other problems they have such restricted labor practices in cast that business is moving to any place other than Germany. The Government, even though they are social democrats, has realized this and is pushing for a number of legal changes.

India is an interesting case of a very closed economy and a very huge bureaucracy that it inherited. I do believe that the bureaucracy has to be attacked and made much more efficient and one would hope that the opening of the economy would force that.

### How will greater free trade impact the current situation?

Shilling: I don't see free trade as a solution. Countries as they develop they import more. They have a huge middle class like India does. But virtually all the developing countries are net exports. They may be importing more, and you have more imports and more exports, it is more demand globally. But I think these countries are growing by exporting and I think there is a serious question, is whom are they going to export to? Bear in mind that the rest of the world depends on the U.S. to buy its excess goods and services, and the American merchandise trade deficit of $520 billion over the last 12 months is the counterpart of surpluses elsewhere.

If the U.S. really does greatly reduce the trade gap because of consumers saving more and their growth in spending both on imports and domestically produced goods curtailed, who is going to replace the shrinking of U.S. demand?

### To what extent have banks' imprudent practices and crony capitalism responsible for the current situation?

Shilling: The banks always get the bad rap. Not that they don't deserve it. You do have bad loans problems throughout the world. But, a lot of the bad financing was in the equity market all the internet stocks. We are coming off a huge bubble of the nineties. We only see it in perspective as we get further away and see all the bad news developing and problems surfacing. I think the real question about this is: will these financial problems cumulate to a point where we get bad deflation? [This is] because bad deflation is preceded by a financial crisis. That is a big question mark at this point.

### Do the recent corporate scandals contribute to bad deflation?

Shilling: Yes, I think they potentially could but I am not convinced that they are going to sink the ship. Although, I do believe that there is enough excess debt both by business and consumer (mortgage and credit card) that the transition to good deflation is going to be difficult. Because again, the real cost of the debt goes up in deflation and very few people are prepared for it. It could be a pretty rough couple of years and it could look like bad deflation even though it will ultimately be good deflation because there is so much debt to be worked down that it will be a very difficult transition.

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