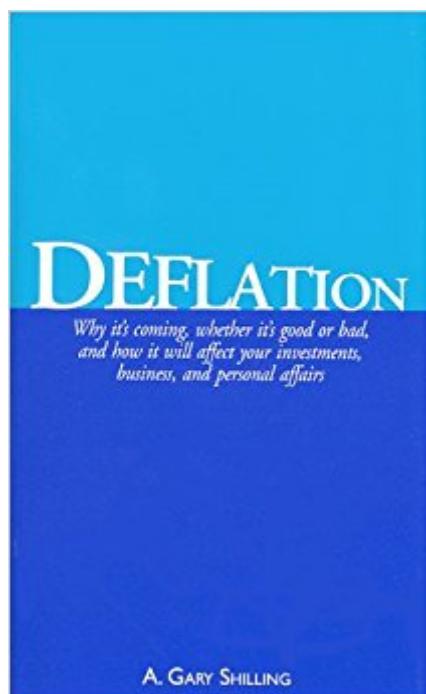


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Deflation: Why It's Coming, Whether It's Good Or Bad, And How It Will Affect Your Investments, Business, And Personal Affairs



Synopsis

Although all eyes have been on Southeast Asia since October, it's not the only game around. A broader look shows that the financial crisis in that part of the world is to global deflation what the 1973 oil embargo was to inflation: it focuses and augments the many forces already at work. For the last two decades, governments, corporations, and new technologies have promoted actions that, given certain triggers, will push prices down. In his comprehensive new book, *Deflation*, A. Gary Shilling points out the deflationary forces at work in the world, analyzes the impact of the Asian financial crisis, and predicts the kind of deflation that will likely result. Governments, for example, have done their part by reducing spending and shrinking deficits. With the Cold War over, US defense spending keeps falling dropping from 7.4% of GDP in the third quarter of 1986 to 4% in the first quarter of 1998. Continental governments endure double- digit unemployment rates to move toward the Maastricht target, deficits no more than 3% of GDP. Deregulation among utilities and services is also lowering prices. In the US, Citizens for a Sound Economy, a Republican think-tank, predicts that deregulation of the electricity market would lead to a drop of "at least 43%" in consumers' electricity bills. Meanwhile, central banks are still fighting the last war, inflation, with higher interest rates. Corporations are adding to deflation momentum with the restructuring that started in the US and UK in the 1980s and has spread to other English-speaking lands. Global outsourcing now provides not only less expensive goods but also cheaper services, including credit card processing and computer programming. Computer and information technology has deflation written all over it. Hardware and software are notoriously prone to price cuts, and users buy the stuff to reduce their own costs. Outside the US, newly industrialized countries as well as countries recently freed from Communism are becoming major players in the export market. The result is a global glut of products and no one to buy them. With Southeast Asia's financial woes, its consumers are not much of a market, and the US the world's happy dumping ground can only buy so much. Faced with increasing global glut, countries wanting to use exports to improve their economies are more likely than ever to devalue their currencies. No doubt a strengthening dollar is deflationary to the US, and no doubt it is currently welcomed by Washington. But what happens as global glut and weak US exports meet rising labor costs, spurred by the drum-tight US labor market, head on? What happens if a profit squeeze kills overpriced US stocks, and individual investors who rely on their equity portfolios as their savings accounts suffer big losses? Consumers retrench. Then they watch prices fall, and in a classic move that makes deflation a self-feeding phenomenon, they wait for prices to go even lower before spending a dime. If, by some slim chance, the Asian crisis proves to be a nonevent for the US, the Federal Reserve will no doubt tighten credit and probably

precipitate a recession, preceded, as usual, by a bear market in US stocks. The net effect on consumer behavior would be the same, and as with the case of an Asian-initiated bear market, the end result would be deflation. When we in the US think of deflation, we think of the 1930s. Its images of soup lines and shanty towns are so vivid that any other idea of deflation pales by comparison. But there was deflation after the Civil War without the financial collapse of the '30s. The deflation Dr. Shilling forecasts coming soon is more likely to be characterized by the oversupply of the late 19th century than the unemployment of the Depression. The final chapters of *Deflation* explain how deflation will affect you. Should you keep your stock investments or switch to bonds? Will your company need to be restructured again? What should you do about inventories? Have you personally been saving enough? Dr. Shilling gives you 13 investment strategies, 18 business strategies, and five personal strategies that will work in the deflationary years ahead. Be prepared. In future years we may conclude that in the summer of 1997, Asia was the trigger for global deflation.

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Dr. A. Gary Shilling is president of A. Gary Shilling & Company, Inc., economic consultants and investment advisors, managing individual and institutional accounts. The firm also publishes INSIGHT, a monthly report of economic forecasts and investment strategy, and Dr. Shilling advises Thematic Investment Partners and Thematic Futures Fund, investment partnerships oriented toward economic, financial, and political themes. A regular columnist for Forbes magazine, he has been twice ranked as Wall Street's top economist by Institutional Investor magazine's poll of financial institutions , and Futures magazine ranked him the country's number one Commodity Trading Advisor in 1993. Although Dr. Shilling does not yet manage any mutual funds, CNBC anchor Bill Griffeth was so impressed with his investment approach that he profiled him along with 19 well-known mutual fund managers in his 1995 book, The Mutual Fund Masters. Dr. Shilling is well known for his forecasting record. In the spring of 1969 he was among the few who correctly saw that 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. In the late 1970s, when most thought that raging inflation would last forever, he was the first to predict that the changing political mood of the country would lead to an end of severe inflation, as well as to potentially serious financial and economic readjustment problems. His first book, co-authored with Kiril Sokoloff, was published by McGraw-Hill in the spring of 1983 and entitled Is Inflation Ending? Are You Ready? In it, the authors answered the first question in the title with a resounding yes. But to the second they said, no, you're not ready. Your investments, your business, and your personal life are geared to inflation lasting forever, not disinflation. Your portfolio is crammed full of tangible assets like coins, antiques, and real estate the great inflation hedges of the 1965-80 era of accelerating prices, but assets that would suffer as inflation rates fell. At the same time, you own far too few financial assets, especially stocks and bonds disastrous investments in periods of high inflation, but great winners in disinflation. Inflation, however, was so deeply ingrained in everyone's thinking that the initial signs of its exit were ignored.

The book's reviewers basically dismissed the authors' ideas. But by the mid 1980s, their forecast of inflation's demise began to look credible. In a delayed victory of sorts, David Warsh of the Boston Globe essentially reviewed the book in that newspaper's March 13, 1986, edition, and Bruce Ramsey did the same for the April 2, 1986, issue of the Seattle Post Intelligence in an article entitled "A preposterous economic prediction that came true." By then inflation rates not only had fallen considerably, but stocks and bonds were thriving while tangibles were in trouble. Dr. Shilling was convinced that more of the same lay ahead because the world of shortages seemed to be over and a world of surpluses was in prospect. His second book, *The World Has Definitely Changed New Economic Forces and Their Implications for the Next Decade* (Lakeview Press, 1986) , spelled out this thesis. The 1987 stock market crash raised the possibility that deflation and not just low inflation might be in the cards, and his third book, *After the Crash, Recession or Depression?* (Lakeview Economic Services, 1988), explored this idea. Despite the title, he wasn't specifically forecasting deflation, but came closer to doing so when he, assisted by Anne D. Willard, created "The Deflation Game" in 1989. It's a Monopoly-like board game that is biased toward winning with financial asset holdings and losing with tangibles. Dr. Shilling is widely recognized as the world's oldest living disinflationist, since his forecast of low inflation is over 20 years old and his suggestion of possible deflation has been around for about a decade. He received his A.B. degree in physics, magna cum laude, from Amherst College, where he was also elected to Phi Beta Kappa and Sigma Xi. He earned his M.A. and Ph.D. in economics at Stanford University. Before establishing his own firm in 1978, Dr. Shilling was Senior Vice President and Chief Economist of White, Weld & Co., Inc. Earlier he set up the Economics Department at Merrill Lynch, Pierce, Fenner & Smith at age 29 and served as the firm's first chief economist. Prior to Merrill Lynch, he was with Standard Oil Co. (N.J.) where he was in charge of U.S. and Canadian economic analysis and forecasting. In addition to writing for *Forbes*, Dr. Shilling is a columnist for Standard & Poor's *CreditWeek* and a member of The Nihon Keizai Shimbun (Japan Economic Journal) Board of Economists. He appears frequently on business radio and television shows. Dr. Shilling is on the Board of Directors of National Life of Vermont, the Heartland Group of mutual funds, the American Productivity and Quality Center, Palm Harbor Homes, the Episcopal Evangelism Foundation of which he is Chairman; an Advisory Director of Austin Trust Company; a Trustee and the Treasurer of the General Theological Seminary (Episcopal); and a Chairman of the New Jersey State Revenue Forecasting Advisory Commission. He is also an avid beekeeper.

Good explanation of why inflation probably will not be a problem in the not too distant future. His

reasons: demographics (boomers are aging and buy less) (generations since boomers have been smaller, purchase as much to keep prices rising) (virtually no wage gains for so long means companies cannot pass on price increases) (low interest rates for a long time do not seem to have generated run away inflation) (increased competition all over the world) This is a good book on a subject most folks haven't considered. This book would give a good foundation in the concept of deflation - it was last serious during the Great Depression of the 30's.

Deflation never happened. Maybe it was all the money the Fed pumped into the economy for problems that never happened like the Y2K or Millennium bug. Then we got the housing and real estate bubbleflation followed by a panic and more money pumping. With so much officious meddling how can you forecast anything? I guess we'll just have to keep on flying by the seat of the pants.

Dr. Shilling's book is very well written. While it reinforced my suspicions that we are entering a deflationary era, it also provided a necessary historical perspective about "good" and "bad" deflations -- necessary perspective because most people (including me before reading this book) associate the word deflation with the Great Depression. The author's writing style makes the topic accessible to everyone. The book loses one star because of the lack of an index.

Good source of what to consider when trying to decipher situation, old data

Shilling predicts good - rather than bad deflation (at least for the USA): i.e. surging demand absorbing excess supply because of price falls. It is a US-centric view - weaker on the international side. Deflation addresses an important & neglected subject. The slow start is tolerable because of good, up-to-date graphs and data generally. Happily he is consultant-clear rather than economist-arcane. His analysis of the US economy is compelling & useful for foreign readers. Nonetheless, there are questions: will policymakers (including central bankers) not adjust; e.g. I understand that defense spending has started rising again. Shilling's review of factors such as the internet is useful. The foreign material is poorer - though his Asian chapters are good. Bizarrely for such a serious & scholarly work, there is no index. Shilling is worth reading - he thinks the west will experience 'good' rather than 'bad' deflation - but how deep will the Deflation be and how long will it last? He could have usefully studied natural resources in more depth; after all, this is where deflation hit hardest and earliest. I will read him again.

This book might better be called "Shilling on Deflation" -it rivals the mega best-seller "Bogle on Mutual Funds." You might buy it just for the incredible historical charts and facts which are unavailable elsewhere. One thing it lacks, however, is a concise argument why we would encounter mild deflation without being on the gold standard - which historically has caused mild deflation for decades in the 1800's and early 20th century. I do not see how the U.S. consumer is going to suddenly turn into a Japanese-like saving machine, on Alan Greenspan's watch, unless Greenspan screws up very badly. Nevertheless, this is the guy who published in 1983, "Is inflation ending? Are you ready?" - ignore him at your own peril! His investment and saving strategies also justify the purchase price of the book.

Bent on the position that deflation is coming. If Asia is not the stimulus than the blundering Federal Reserve will be. I disagree. Most successful companies are already making plans to address the global overcapacity. Asian countries cannot continue to devalue currencies in a vacuum since devaluations cripple the local populations. The author essentially assumes that the forces of the world will stupidly and blindly force deflation. While many of the world's leaders are far from perfect, the critical leaders fundamentally understand that good economics is good politics. Bad economics might be good politically now (e.g. deficit spending), but ultimately the situation crashes and the politician suffers (i.e. Asia's leaders). In sum, if you want to be pointlessly scared, please read this book. Remember, a messenger's credentials do not make the message correct.

Loaded with charts to support his thesis, Shilling provides compelling evidence that inflation is dead, at least for the next 5 years. He cites China's need to export to grow, a competitive force unlike anything we have faced before. He also is convincing in his argument that a global economy means downward pressure on prices here and abroad. My suggestion is to read the last chapter first, so that the data takes on even more significance as the reader plows through it. All in all, a good explanation of macro economics from a not too esoteric economist.

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