

# Weekly Perspectives

Website: [www.lomam.com](http://www.lomam.com)

Email: [info@lomam.com](mailto:info@lomam.com)

[iraj.pouyandeh@lom.com](mailto:iraj.pouyandeh@lom.com)



## A Weekly View of Global Economies

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Business fixed investment has been growing at a decent rate in the US over the past two and a half years, rising from the low level it reached in 2003. And the hope is that it will continue to grow at a sufficiently fast pace to take up the slack, if consumers stumble. We need hardly be reminded that consumption in the United States has often been an important factor in shoring up global growth.

Meanwhile, in China, the main impetus continues to come from capital spending. And glancing at the overall global scene, investment expenditure is quite robust. But all this capacity creation may appear a little worrying. The main concern centres on the sufficiency of aggregate demand to mop up the extra output that can be brought to market.

The principal question is whether there will be enough broadening of global consumer demand away from the United States and towards Europe and Asia. Well, there are some indications of consumption spending looking more robust in places as far apart as Germany and Japan. But it is too early to say whether consumers in such countries are a worthy stand-in for the redoubtable American spender. So the outcome may still depend on the latter continuing to show some fortitude in the face of interest-rate headwinds.

Apart from the issue of expanding capacity to satisfy projected demand, there is also the question of competitiveness. Firms may see the need to invest in new capital and technology in order to garner a competitive edge over their rivals. To this end, a corporation may be willing to write off plant and equipment - - which also includes hardware and software - - at a rapid rate of depreciation. The old stuff is replaced with the new, giving them better odds of winning the battle against competitors.

In a competitive system there is real motivation to be efficient, because the cost of failure is high. But, of course, the willingness to spend on equipment and technology must be backed by the ability to pay. The curious thing about this system is that good earnings give the firm the wherewithal to spend, while the implementation of better equipment and technology make it possible to generate higher profits. This can become a virtuous circle for winners and a vicious one for losers.

The "New Economy" rhetoric that surfaced at the time of the tech bubble in the stock market, a few years ago, exaggerated the extent of the changes actually taking place. At the same time, we have to admit to a kernel of truth in these views, namely that there is indeed some enhancement to productivity from implementing new technology, as well as making the extra investment. What's more, the changes are ongoing.

Inevitably, the process will involve a measure of creative destruction, to use Schumpeterian phraseology. The theory was first advanced by the economist Joseph Schumpeter in the nineteen thirties. According to this view, change does not occur at a slow equilibrating pace, but in a jarring manner characterised by disequilibrium.

There is a good deal of evidence to support this theory, and it still holds true even in an age when pervasive government intervention aims at protecting threatened sectors from destruction. Yes, the destruction is painful. Jobs are lost and entire industries disappear. But it is also creative, because out of the ashes of the old arise new activities, jobs, products and

services. Such is the nature of economic development and government protection may merely delay and exacerbate the pain necessary to bring about the eventual adjustment.

Currently, there are several strains of technological change underway, ranging from bio to nano. One technological theme is grouped around the adoption of exchange through the internet and mobile communications. Their pervasive impact on economic activity is evident in all countries, whether in the first or the third world.

One thing we have to do is to distinguish between the efficiency gains from capital renewal and technological change, and the beneficial effects of globalisation. The latter refers to the rise in productivity due to the efficient international allocation of resources and the opening up of markets to competition. But globalisation may also give an impetus to capital spending and the interchange of technology.

One train of thought is that technological change, globalisation and productivity gains have created an essentially deflationary mode for the global economy, reminiscent of the late nineteenth-century period. In terms of the fundamental forces at work, there is truth in this argument.

But inflation is affected by both real and monetary forces. The monetary system in place during the late nineteenth century was substantially different from the one operating in most countries today. In particular, the gold standard prevented authorities from deliberately targeting inflation. Furthermore, governments did not take direct responsibility for economic growth or the unemployment rate. The price level, growth and employment fluctuated far more than is currently acceptable. This was partly the result of a large goods sector relative to services, but also because authorities followed a hands-off policy.

In the period since the Second World War most countries have implemented activist monetary and fiscal policies, and that is still true today. The inflationary period of the 1970's resulted from a deliberate choice to validate inflation rather than suffer slumping demand. When the damage from high inflation was judged to be too onerous for the economy the authorities switched to fighting it, in the early eighties.

The lesson to be drawn from all this is that we should not be too comfortable in the view that inflation is dead. Central banks have the ability to pump liquidity into the economy if the decision is taken to validate inflation. Japan's deflationary experience, of the past decade or so, was a special case of particular circumstances and policy errors. Other countries may face different conditions and options for policy action.

**Iraj Pouyandeh**  
*Strategist / Senior Portfolio Manager*

*Prior to joining LOM Asset Management, Iraj Pouyandeh worked for Sun Life Financial in Toronto, advising on the global economic and financial outlook and strategy for the company. He manages the LOM Global Equity Fund.*



LOM Asset Management Limited  
27 Reid Street  
Hamilton, HM 11  
Bermuda  
441-295-6999

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