

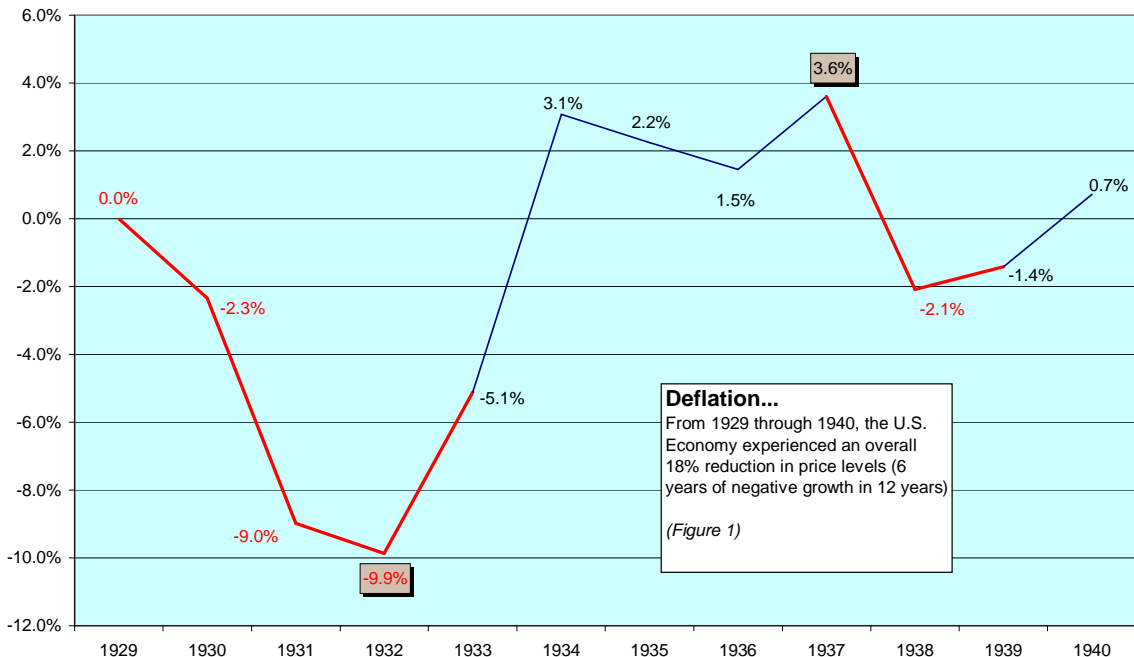
# An Economic Newsletter for the New Millennium

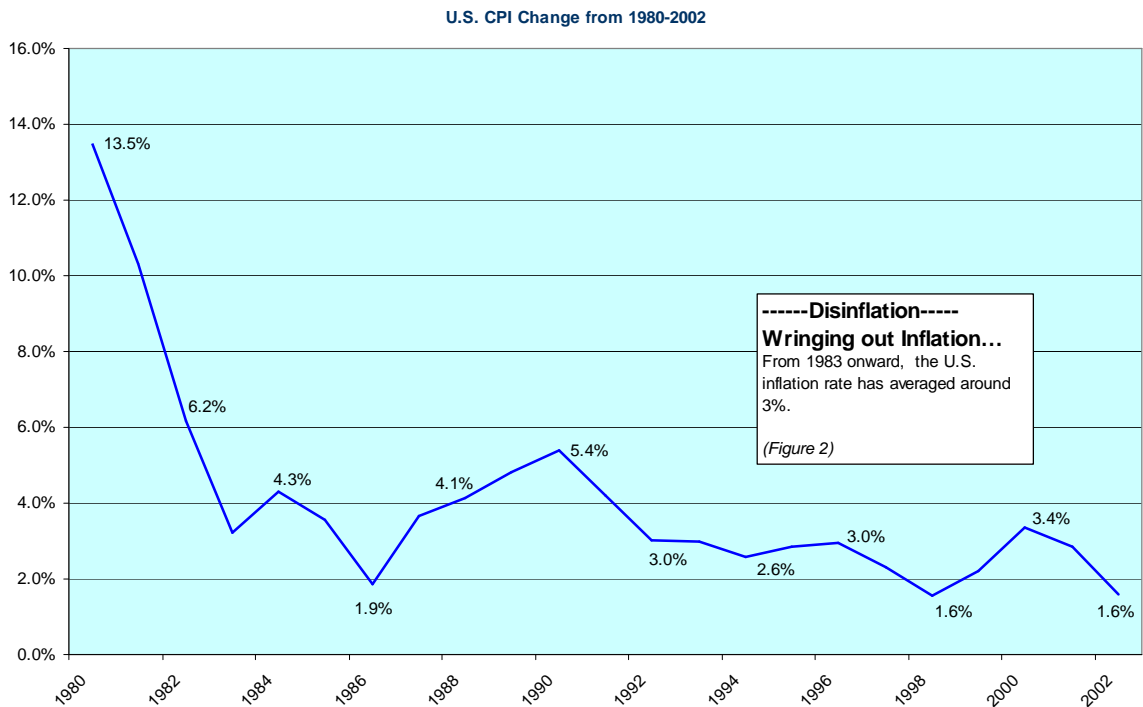
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(Volume 2003: Issue 2) September 9, 2003

## DEFLATION

For the past couple of years, a variety of pundits have voiced fears of impending deflation, declaring it vastly more dangerous than inflation. Even the Fed, on a number of occasions, has joined the chorus and fanned the flames. The last time the U.S. economy experienced any serious and prolonged deflation was during the Great Depression of the 1930s. Deflation is the phenomenon in which the weighted-average of prices is falling (Note: this is different than disinflation, which means that while prices are still inflated, the rate of increase in prices is falling). The deflationary period of the 1930s was caused by a collapse in demand and by gluts in many markets; recent deflationary pressures come from a far different source (See Figures 1 & 2). The inflationary bias, marking the post World War II American economy, has gradually subsided and given way to encroaching competition – it is the increasing presence and pervasiveness of competition that has contributed the most to our current experience with deflation.

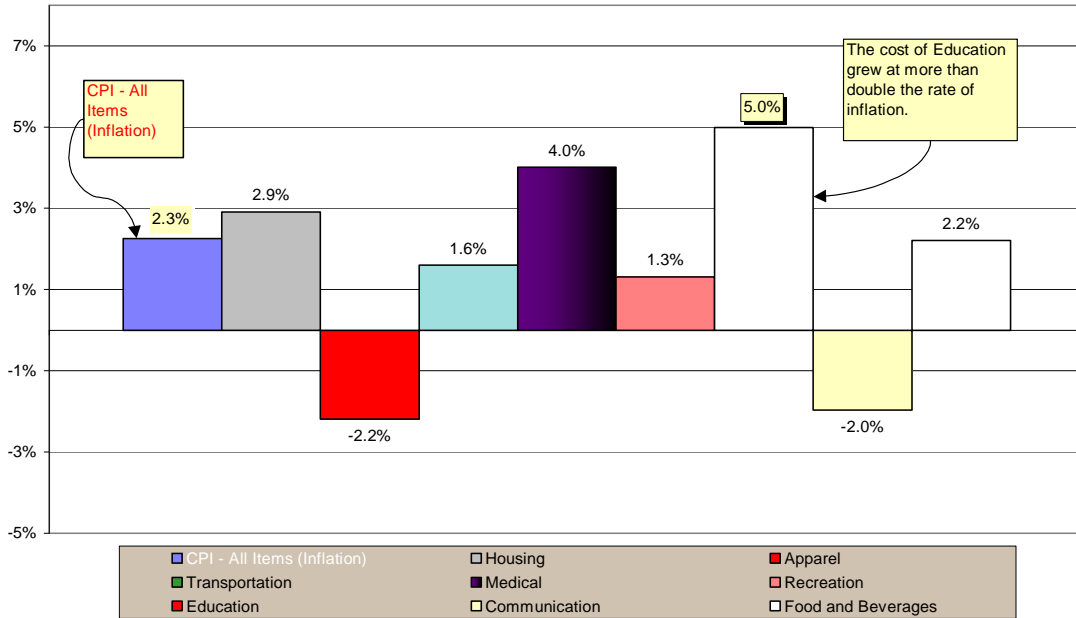
Annual CPI Change from 1929 through 1940  
U.S. Department of Labor  
Bureau of Labor Statistics  
U.S. City Average / All Items



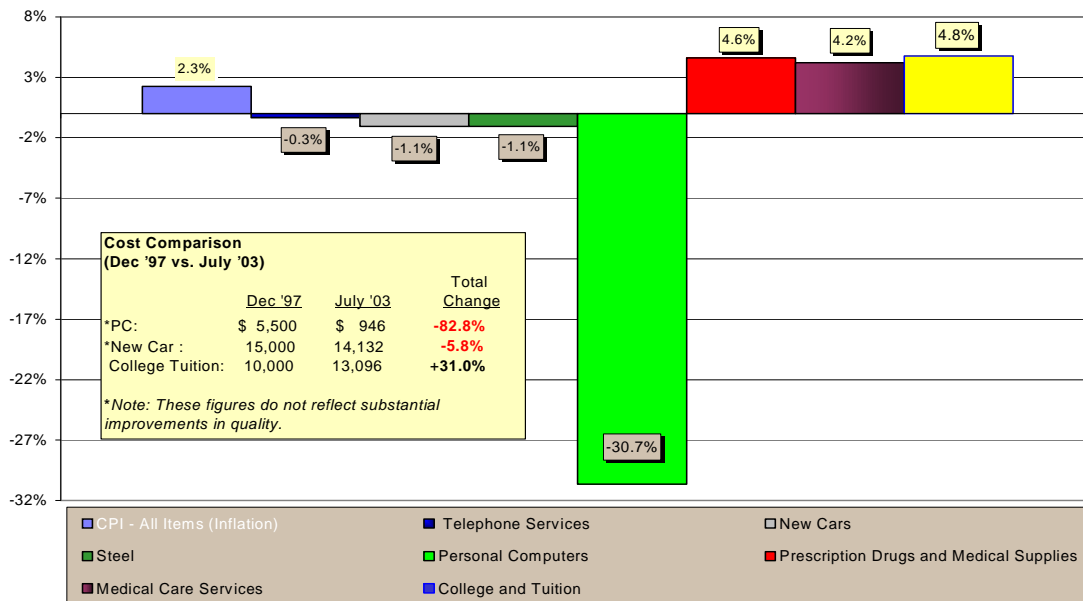


### *Competition...*

**The essential argument of the *New Paradigm in Economics* is that as competition in markets increase, the power to control price by firms in those markets decreases.** A number of markets in the U.S. have been going through this process since the Second World War, when cartelism had reached its zenith. Over past decade or two, the U.S economy has experienced a tremendous up-tick in competitive pressure. Among these transformed markets/industries are telecommunications, automotive, computer and steel. In the distant past, as the product markets became less competitive, so did the labor and capital markets that served them. The Big Three in the auto industry saw the rise of the United Auto Workers; Ma Bell saw the growth of the Communication Workers of America; and the cartelization of the steel industry led to formation of the United Steel Workers. The surplus profits realized in the early days of these industries provided incentive for labor unions to organize with the objective to obtain surplus compensation. In the economic literature, surplus reward to productive resources such as labor and capital is termed ***economic rent: the reward to productive resources in excess of their opportunity costs that which must be paid to bring them into employment from their next best competitive alternative and keep them employed.***



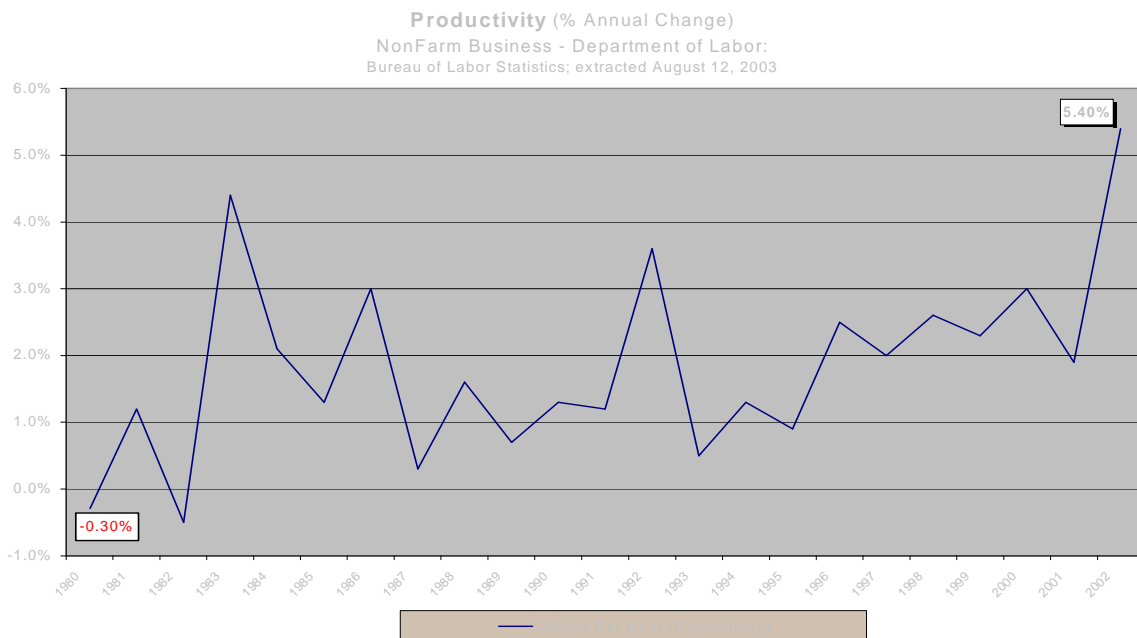
...the reader will note from the preceding and following charts that the inflationary bias in the economy resides in sectors such as education and medicine, while the increasingly competitive sectors such as computers and autos exhibit deflationary tendencies.



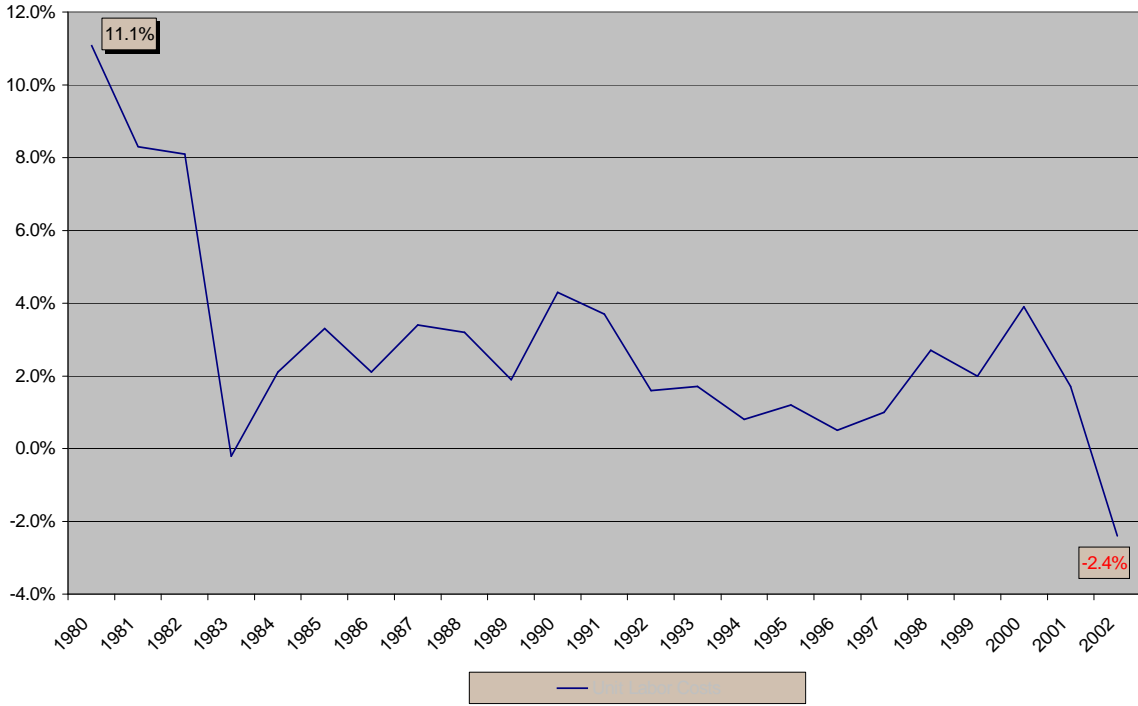
It must be understood that all resources including the suppliers of debt capital, suppliers of equity capital, as well as suppliers of labor, must all earn their opportunity cost. When the rate of return to equity investors falls below the opportunity cost level (when the investor can realize a better return elsewhere in the equity markets), those firms will either have to raise their prices, restructure to lower costs or gradually shrink in size and exit. In the past, many firms and industries were able to exercise market power such that they were able to raise prices and reduce output in order to increase their profits and their rate of return on equity. As markets become increasingly competitive, the option of raising prices to increase revenue and profits up to at least their opportunity cost profit levels (and correspondingly, required rate of return on investment) no longer works. As competition spreads through markets, price increases become less and less revenue enhancing; eventually these price increases will cause revenue to fall. In economic analysis, the relationship of price, units sold, and revenue is called price elasticity of demand.

As surplus profits disappear and fall below the level affording a reasonable rate of return on investment in equity capital, costs must be lowered through restructuring to return to reasonable profitability. Simply put, equity capital requires a reasonable return on investment; yet another form of opportunity cost. Automation, outsourcing, contract labor, and moving to geographic regions with lower cost structures (labor compensation, taxes, energy costs, etc.,) will occur until profits are restored to a level where they yield a reasonable rate of return to equity investors.

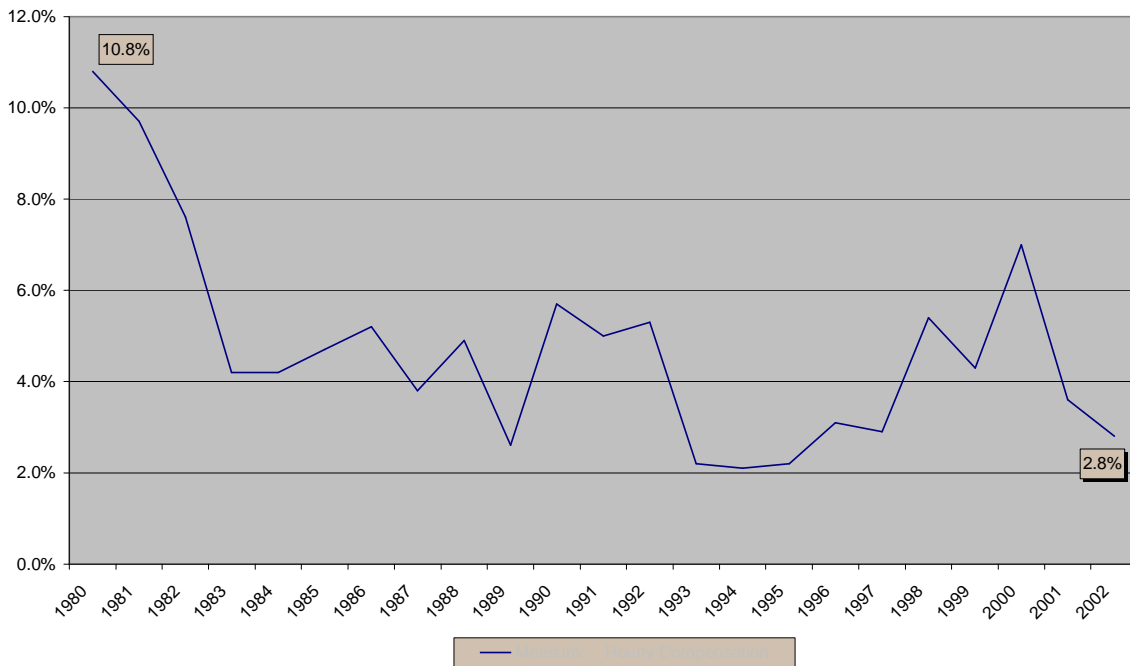
As competitive forces push prices downward, firms, to remain viable, must respond by cutting costs, including labor. A rise in productivity results when the same or fewer labor hours employed produce more output – the increase in labor productivity often cited by the media occurs for this reason. In the case of automation, less labor works with more capital to achieve the increase in productivity (throughput).



**Unit Labor Costs (% Annual Change)**  
NonFarm Business - Department of Labor:  
Bureau of Labor Statistics; extracted August 12, 2003

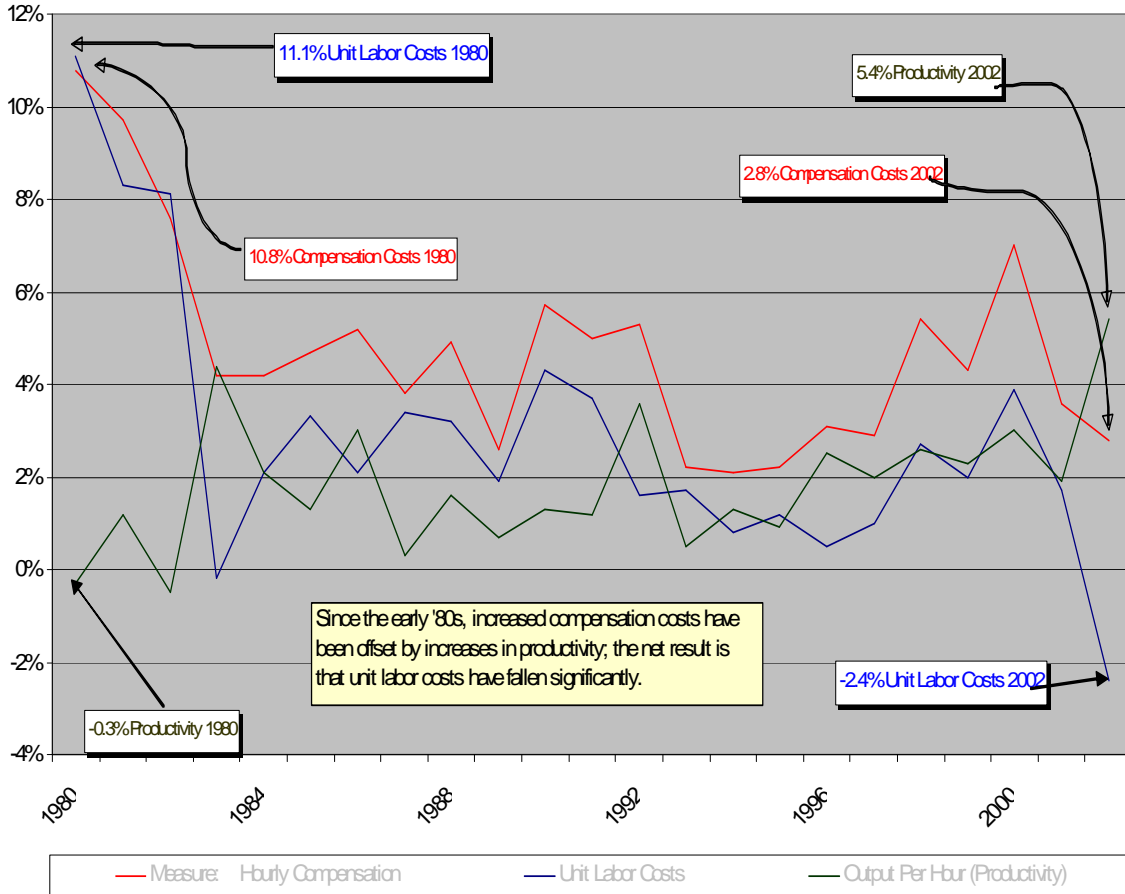


**Hourly Compensation Costs (% Annual Change)**  
NonFarm Business - Department of Labor:  
Bureau of Labor Statistics; extracted August 12, 2003



### Unit Labor Costs (Compensation/Productivity) (%Annual Change)

NonFarm Business - Department of Labor.  
(Bureau of Labor Statistics; extracted August 12, 2003)



### *A lesson in the importance of productivity and job security as measured by unit labor costs...*

Harry V's contribution due to his effort alone and net of other productive resource contributions, is 20 units per hour. Harry's total compensation per hour is \$ 40. When we divide his hourly compensation by the units he alone produces, it is called the unit labor cost, which in this case is \$ 2.00 per unit. If Harry's productivity rose by 10% to 22 units per hour while his total compensation remained the same ant \$ 40 per hour, the unit labor cost will fall to just under \$ 1.82 per unit. The firm would be better off and Harry would have more job security. The cause of this increase in labor productivity could come from a variety of sources. Harry may have increased his human capital by attending workshops or additional courses. Harry could be working with more or better

physical capital such as CAD/CAM; this latter case would be called automation. Some of Harry's colleagues could have been laid off permanently and Harry has picked up the tempo. There are many reasons but they all lead to a rise in productivity and a fall in unit labor cost.

Let us go back to the original case where unit labor cost was \$ 2.00. Now assume that productivity is constant and Harry's compensation per hour rises by 10% to \$ 44.00 per hour. The unit labor cost will rise to \$ 44 divided by 20 units or \$ 2.20 per hour. The firm is worse off and while Harry's compensation per hour rose, he has less job security. If Harry's firm is in a very competitive industry like autos and the firm has no power to raise the price, profits and return of investment to the equity capitalist will fall. If it falls to a return on investment that is less than the opportunity cost level, the firm will eventually shrink or may exit entirely. To stay in business, the firm must restructure and cut costs – in this case, unit labor costs.

The general rule is that as long as the percentage increase in labor productivity is greater than the increase in labor compensation, unit labor costs fall. When the percent increase in labor compensation exceeds the percent increase in labor productivity, unit labor costs rise. When the percentage increase is the same for both, unit labor costs are constant.

### ***...Restructuring Happens***

Unit labor costs can effectively be reduced by buying the labor indirectly through outsourcing. Typically in the auto industry, labor compensation is significantly lower at supplier firms and hence there is much incentive to outsource production rather than make it in house where labor costs can be double that incurred by supplier firms. Many firms have relocated to lower cost areas. It is not always labor costs that cause similar decisions to be made. Energy costs, taxes, and environmental compliance costs can also affect the decision-making process.

When deflation is occurring because increasing competition is putting downward pressure on prices, it tends to force a reduction in economic rent or surplus rewards to productive resources. The lower prices consumers pay increases what economic literature calls...

***Consumer Surplus...***at any given level of “money” income consumers earn, they can buy more goods and services in real terms as deflation occurs - it’s not what you earn, but what you can buy with what you earn.

*In societies like ours, there is a widely held majority view that the income distribution coming from the market is too unequal; to address this perceived problem, higher income people are taxed and the revenues are transferred to lower income people (i.e., transfer payments). The personal income of the poorer segment of the population is greater than the income they actually earn in the market – the opposite is the case for the higher income portion of the population. This is the effect of the tax-transfer payment process.*

*Since the entire population are consumers, and the portion of the population that supplies productive resources is smaller than whole, then increasing competition passes the productivity dividend along to the consumers in the form of lower prices and higher consumer surplus rather than back to the productive resources in the form of economic rent, or producer surplus: income distribution is more equal as competition increases in markets, even without the tax-transfer payment process.*

### ***Increasing competition, restructuring, and the real rate of economic growth***

One of the reasons for publishing this newsletter was to interpret current economic behavior and the data reflecting that behavior through the eyes of the *New Paradigm in Economics*. Most are painfully aware of the down side of this landscape change in the American economy, namely a very large number of well qualified and experienced workers that are structurally unemployed. Many do not fully realize the reasons for this phenomenon nor do they realize the long-term beneficial effects of this landscape change. This is especially true of the impacts of the *New Paradigm* on the income distribution and the rate of potential real economic growth. While a complete understanding of these impacts requires knowledge of very difficult economic theory, the next paragraph will attempt to explain the benefits in simpler terms.



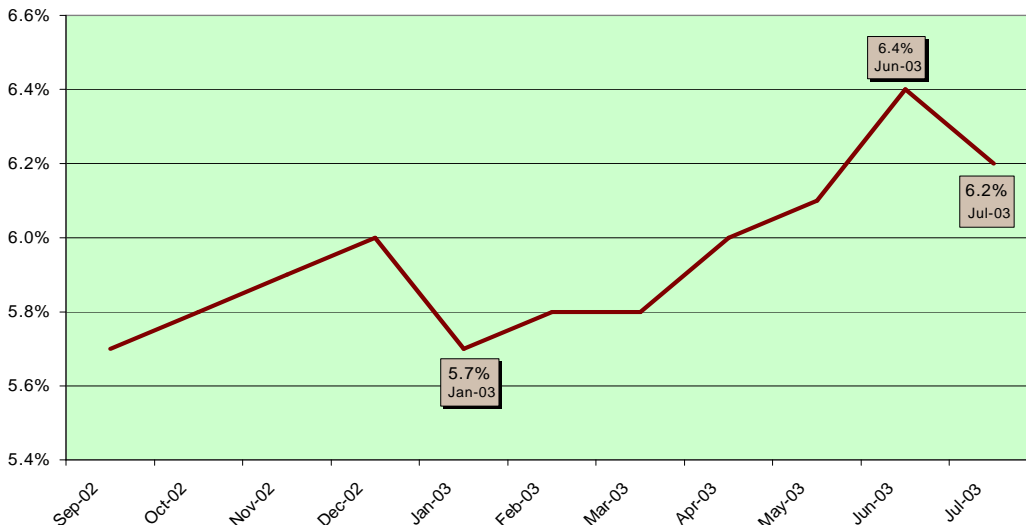
The restructuring that has been going on for several years, has accelerated in recent years. In fact, since the economy has been in a recovery/expansion phase for over seven quarters, most of the remaining unemployed (plus discouraged) workers no longer looking for work, are structurally unemployed, not cyclically unemployed. (See previous issue of this newsletter for a distinction between various types of unemployment.) These structural layoffs of workers are usually necessary for firms to survive. In the case of automation, e.g. CAD/CAM, labor productivity increases and causes the unit labor costs of this less labor intensive production mode to decrease. For society, however, the productivity dividend is not achieved until the structurally laid off workers are reemployed. Until that occurs, the additional output that would come from the employment of this labor is aborted and no dividend occurs to society. This not only means that a higher rate of real economic growth can be achieved, but that it is in fact required so that the structurally unemployed are re-deployed for us, as a society, to receive this painfully achieved productivity dividend. In simple terms, this restructuring means: a higher per capita standard of living once the structurally unemployed are back to work.

## Current Statistics (8-29-2003)

### ↓ Unemployment Rate (6.4% Jun – 6.2% July)

The recent report from the Bureau of Labor Statistics showed the unemployment dropping from 6.4% in June to 6.2% of the labor force in July – this constitutes the first drop in the monthly unemployment rate since January 2003.

Monthly Seasonal Adjusted Unemployment Rate  
(Department of Labor: Bureau of Labor Statistics)  
August 29, 2003



 **GDP** (2nd Quarter 2003 Real GDP: 3.1% - Revised from 2.4%)

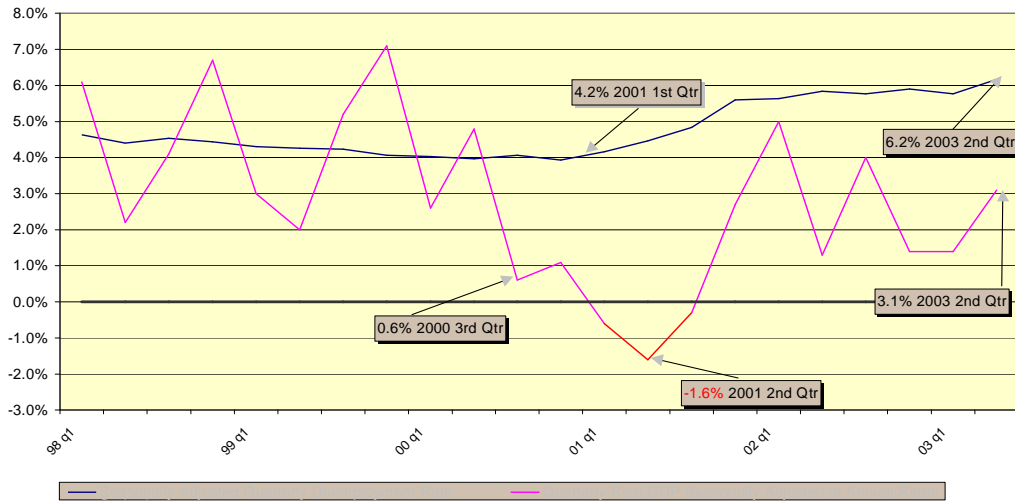
The second quarter of 2003 showed continued positive growth in real GDP. The Commerce Dept reported a 3.1% growth rate for the 2nd Quarter 2003 (on an annualized basis), revised upward from last month's initial estimate of 2.4%. It marked the 7th consecutive quarter of economic expansion, allaying fears of a double dip recession. At this rate, indicators argue that the 3rd Quarter of 2003 will confirm continued economic expansion.

...given the fact that indices overstate the inflation rate due to quality-blindness, isn't it quite possible, looking at the following table, that there was never a recession at all?

<b>What Recession?</b>														
<b>Seven (7) quarters of economic growth and counting!</b>														
(2nd Qtr 2003 revised upward from 2.4 to 3.1)														
Bureau of Economic Analysis														
Table 8.1. Percent Change From Preceding Period in Selected Series														
[Percent] Seasonally adjusted at annual rates														
Today is: 8/28/03 Last Revised on August 28, 2003 Next Release Date September 26, 2003														
	2000				2001				2002				2003	
	I	II	III	IV	I	II	III	IV	I	II	III	IV	I	II
<b>Gross domestic product:</b>														
Current dollars	5.7	7.3	2.2	3.2	3.0	0.9	1.9	2.2	6.5	2.5	5.1	3.2	3.8	4.0
Chain-type quantity index	2.6	4.8	0.6	1.1	(0.6)	(1.6)	(0.3)	<b>2.7</b>	<b>5.0</b>	<b>1.3</b>	<b>4.0</b>	<b>1.4</b>	<b>1.4</b>	<b>3.1</b>
Chain-type price index	3.1	2.3	1.6	2.1	3.7	2.5	2.2	(0.5)	1.3	1.2	1.0	1.8	2.4	0.8
Implicit price deflator	3.1	2.3	1.6	2.1	3.7	2.5	2.2	(0.5)	1.3	1.2	1.0	1.8	2.4	0.9

...to reduce unemployment, most of which is structural, an even higher rate of expansion will be needed. This marks a departure from past cyclical trends of unemployment tracking closely to real GDP (but in and inverse manner). Since 2001 this has not held true because the nature of the unemployment was structural, not cyclical – hence, it has remained very high.

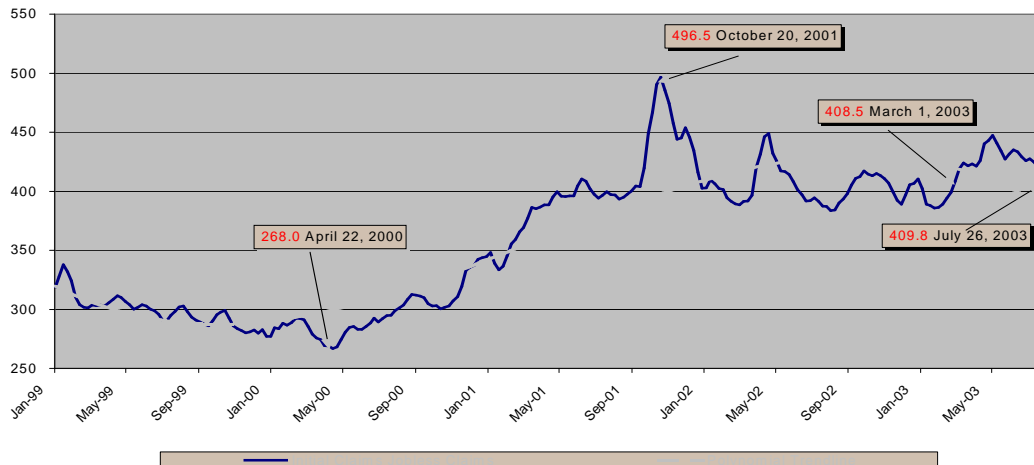
Unemployment & GDP (Quarterly)  
 1998 1st Quarter - 2003 2nd Quarter  
 Data from U.S. Dept of Labor (Unemployment)  
 Bureau of Economic Analysis (GDP)  
 August 26, 2003



**Jobless Claims** (4-wk rolling avg: 395,750 Aug-16 to 396,250 Aug-23)

Department of Labor data indicate that the new jobless claims are trending slightly downward and there have been four consecutive weeks of claims below the 400,000 mark, generally viewed as the level signifying economic expansion. On a further note, a Department of Labor spokesman said about 2,000 to 3,000 new claims had been delayed because of the power blackout two weeks ago in the Northeast, offsetting the slight rise in the reported numbers. Again, given the large number of structurally unemployed workers, this is heartening news. This continues to hammer home the point that unless the structurally unemployed workers are re-employed/redeployed, the productivity dividend realized by society as a whole is delayed.

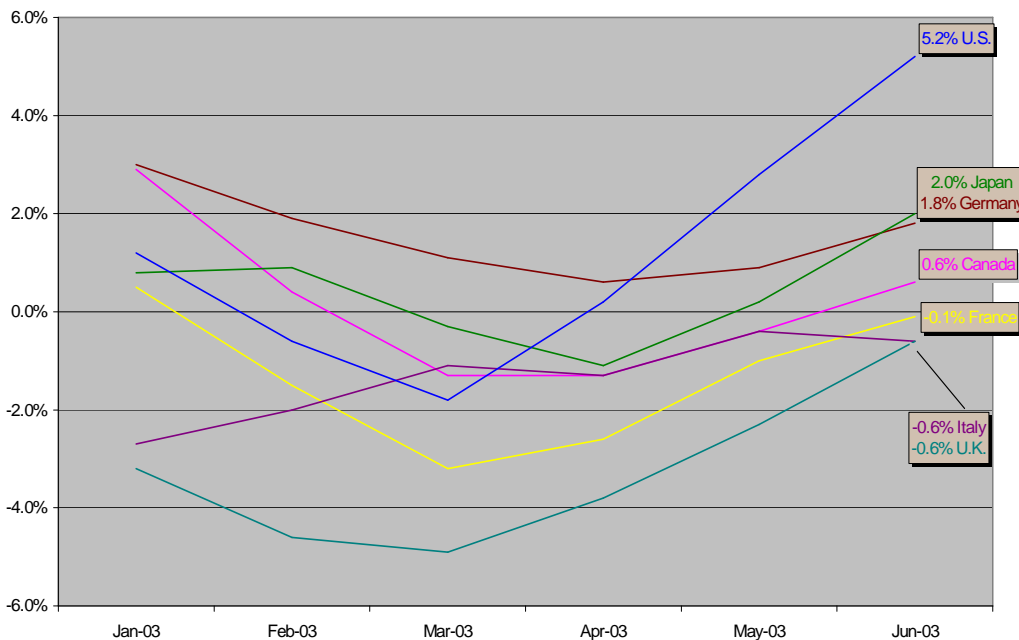
Initial / Jobless Claims (thousands)  
 Rolling 4-Week Average  
 Jan 1999 - July 2003  
 Data from U.S. Dept of Labor  
 August 26, 2003



**Leading Indicators** (5.2% up tick in U.S. for June 2003)

According to figures released by the Organization for Economic Cooperation and Development (OECD), “Moderate growth lies ahead in the OECD area and the United States according to latest composite leading indicators (CLIs). June data signal strongly improved performance in the United States and slightly improved performance in the Euro area and Japan.”

OECD Composite Leading Indicators  
Six-month percentage rate of change of trend - annualized  
(Paris, 8 August 2003)



**Durable Goods** (June - July +1.0% Consumer Durable Goods; Machinery + 1.8%; Computers and Electronics +1.9%)

Durable Goods have trended downward from their peak in 1999, but have more or less flattened since then. However, Durable Consumer Goods, which reached a trough at the end of 2000, have been trending upward. Over the same period of time, non-Consumer Durable Goods has remained relatively flat with an up tick in the last few months.

## **Trade**

Despite the fact that the OECD Leading Indicators show the U.S. expanding more rapidly than other countries, it does not appear that a significant “locomotive effect” (rising GDP associated with an increase in imports rising faster than exports) has occurred. This can be seen by the recent improvement in the U.S. Trade Balance - rise in Net Exports).

 **Price Indices** (CPI – Urban Consumers: July 1.3% annualized rate; PPI – Finished Goods: June – July 0.1% monthly rate)

The silence attributable to inflation continues to be deafening...yawn.

## **10-year U.S. Government Bond Rate**

In the government securities market, despite the ongoing expansion, the 10-year rate still remains between 4.4% and 4.5%.

## **Letters/Commentary from our Readers**

**Hello,**

I think I have a good example of restructuring, but I need to get the details. Boeing is in the process of retooling their whole supply and procurement system. Their previous system was designed around very large orders. The new system will lower the effective start-up cost on small contracts by making customization much cheaper. It currently takes a team of engineers weeks to spec out and create order lists for a new customization. They want to get that down to a single engineer and about eight hours. It's costing them a fortune to put the system in. So it sounds like a pretty classic case. Their buyers are less and less a “Big Three” and more and more a bunch of smaller airlines. Every airline needs some level of customization, because they all make their own choices with respect to exactly what amenities they need: size of first class, density, etc. Even the controls can be different depending on the duty the jet is designed for. Apparently not every jet in every model is rated for the same distance/conditions. So if you don't fly transatlantic and you don't have flights over x miles then apparently you can get by with a slightly cheaper plane. So here's an example of a very large company spending quite a bit of money during a period in which sales are off to retool it's cost structure in favor of smaller buyers. Seems like the sort of example you want.

## **Tim from Seattle**

*Tim, not only is what you relate a good example of what is explained in the New Paradigm in Economics, it is the archetype of how American firms will have to respond to changing market pressures in the future. Let's hear it for the American Entrepreneurial Spirit responding to the demands of the 21<sup>st</sup> Century!*

## **Hola,**

While the mantra for those of us that continue to have gainful employment is "at least I have a job," I can't help but wonder how many more 80-hour work weeks I have to endure before the management deigns to bring more people onboard. From what I have read, productivity is rising by leaps and bounds, but how much more of this can we take?

...also, what is the textbook definition of 'deflation'?

## **"Overtaxed" George in San Diego**

*From a strictly mercenary point of view, your 40-hours of overtime a week is probably 50% less expensive to your employer because your benefits are paid for in the first 40-hours you worked this week – subsequently, your employer gains from every hour of overtime you work. The limiting factor, of course is that your productivity certainly declines after a certain number of hours worked. Yes, burn-out is a growing and real fear in the workplace, but employers are hesitant to bring on additional employees because **your** 80-hour work-week is cheaper than two 40-hour work weeks...in the meantime, at least you still have a job, George.*

*...the definition of deflation is "change in prices of a market basket of products over a given period of time." The question then becomes who changes prices? The answer to that is that firms change prices - lowering them in the case of deflation and raising them in inflation. Please note there is nothing inherently wrong with deflation. People fear that deflation will result in lower wages - well, why not? So long as their purchasing power remains intact/improves, who cares?*

## **A comment and a question...**

When I saw the various measures for deflating nominal GDP, to get to real GDP, I noticed that two of the three indices showed no evidence of recession (2 consecutive quarters of negative growth). Why is this?

Any index using a fixed basket, such as CPI and PPI, has a tendency to overstate inflation resulting in a failure to address issues relating to substitution and quality (see the 1<sup>st</sup> Issue). Currently, chain indices address substitution effect issues, rather than quality issues. The point is that the recession itself was very mild, and a more thorough and accurate measure of the inflation rate might not have shown a recession at all.

## **Pat from Plymouth, Michigan**