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The Voice of the Investment Management Consultant

Election Year Wish List for Economic Policy: Are We On the Verge of the Greatest Creation of Wealth in the History Of Mankind?

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The political season for presidential politics is a lot like the Christmas season, except Uncle Sam is Santa Claus. Our wish list as advisors is for the strongest economic policy possible that would afford the electorate the brightest economic future – inflation rates to approach zero, strong real economic growth, low interest rates and rising stock valuations. But, is this “greatest economic future” wishful thinking yet another empty political promise, as it is not in either party’s power to promise? In any other election year, that would be the case, but in August of 2004, we are in a unique economic position. Over the next 10 to 20 years, there is the potential for the greatest creation of wealth in the history of mankind.

Graham Tanaka postulates in his book, *Digital Deflation*, that rapidly advancing technologies have created economic conditions that over the next two decades could be almost as favorable as those of the 1990s. Tanaka makes a well-grounded scientific case that unprecedented improvements in digital technology has fostered unmeasured increases in productivity which have transformed the very foundations of our global economy, rendering 20th century economic metrics insufficient and often stunningly inaccurate in tracking real economic growth. Alan Greenspan’s instincts on increases in productivity, derived from technological innovation, were correct; and we now have the data – thanks to Tanaka – to make the case that digital deflation is occurring. Faster, better, cheaper technology is driving increases in productivity, faster GDP growth, lower inflation rates and lower interest rates, all of which are perfectly aligned with “the brightest economic future” scenario cited above. We are at that unique economic inflection point where our new digital economy is materially impacting our old economy in profound ways. If we play our economic policy right, we could indeed witness the greatest creation of wealth in the history of mankind, far eclipsing the industrial revolution.

The extraordinary economic performance of the 1990s has been a mystery because it contradicted all conventional economic models and prevailing thoughts that had been proven over several decades. The paradox was that the vigorous economic growth of the 1990s was achieved without stimulating high rates of inflation and high interest rates, which were indicated in our best economic models. In fact, contrary to conventional thinking, inflation rates and interest rates were at 40-year lows. This contradictory juxtaposition of growth, inflation and interest rates implied massive increases in productivity, but all conventional measures of productivity did not adequately reflect the 50%+ improvement in the performance of digital technology

year after year being offered at typically lower costs. There was no precedent for measuring quantum leaps in productivity in very short timeframes accompanied by falling prices.

Traditionally, the Bureau of Labor Statistic measured quality improvement by the incremental cost of adding new features/components to a product, like the cost of adding anti-lock breaks to a car. The government would

adjust the price index to reflect the increased cost of the new feature, so the product’s higher selling price would reflect the cost of the new feature and not appear to be inflationary, just because the car’s price went up. But this “cost-based” method of tracking quality (innovation/functional enhancement) did not work well with digital technology, as in digital technology there are routinely 50%+ increases in performance year after year with lower cost than the preceding earlier generation of technologies. New hedonic models can measure the implied value to consumers of each new feature in a product by examining, for example, 50 different configurations of PCs and determining how much more people are willing to pay for another gigahertz of processing power. Because we are seeing 50% improvements in PC-processing power at lower costs each year for the foreseeable future, economists would

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measure the quality improvement as being the equivalent of a 50% reduction in price each year, not taking into consideration that prices having actually declined, which would translate into an even lower cost equivalent. This would be deflationary in the sense that getting more performance at the same or lower cost is the equivalent to a much lower price, or digital deflation.

The deflationary effect is not the bad kind of deflation attributable to a severe recession or depression fostering a downward spiral of prices and wages, but it is the fortuitous result of advancing digital technologies that create greater performance and value at the same or lower cost. Because the government is not counting quality improvement in a great number of technology-driven products and services across the economy, there is enormous potential for underestimating deflation and overstating inflation.

Importantly, the increases in real output and productivity associated with digitally driven products and innovation not only translate into lower inflation in the GDP deflator but also much higher real GDP. By using hedonic models, we gain a more accurate reflection of the greater real value being delivered to consumers at the same or lower prices with every technology product design cycle. In the context of modern economics, this is a rare phenomenon – rapid and constant improvement in digital technology is creating both lower measured inflation and higher real output concurrently. But most importantly, this digital deflation explains the “new economy.” The overstatement of inflation and the missing gains in government-reported productivity that were being anticipated are one in the same; we just weren’t measuring them correctly.

The substantiating proof of the digital deflation thesis came in 2000. As a student of economic science, Alan Greenspan suspected productivity gains were driving the vigorous economic growth of the 1990s, yet he was not convinced the strength in productivity was structurally permanent and could be sustained and/or perpetuated. In order to verify digital deflation, it had to be tested in an economic slowdown or recession. This would confirm the

existence of “more permanent” productivity gains derived from digital/technological innovation. The recession of 2000 was the acid test, affirming conventional economic policy and models were out of synch with the new digital economy. The NASDAQ plunged 50%, and the Fed tightened money supply which, in turn, fueled the desired digital deflation. This rare miscue by the Fed was a watershed event, as it marked the end in the reliability of the old economic model and policy, and the beginning of the new digital economic model. By November 2000 (remember George W. Bush vs. Al Gore), consumer sentiment had plunged precipitously, retail sales slowed abruptly, and many firms used finely honed technology to shut down

IN THE CONTEXT OF MODERN ECONOMICS, THIS IS A RARE PHENOMENON — RAPID AND CONSTANT IMPROVEMENT IN DIGITAL TECHNOLOGY IS CREATING BOTH LOWER MEASURED INFLATION AND HIGHER REAL OUTPUT CONCURRENTLY

inventory supply lines. There was no question the old economic model and associated policy were not working, and a new economic model and policy were needed to illustrate how new digital technologies are boosting product quality, productivity and real economic growth, while reducing inflation to minimal levels.

Not only were the digitally inspired productivity gains found to be permanent, but new digital technologies and the internet helped to compress a normal inventory recession from two quarters into a few months. Even the classic two-quarter definition of a recession would have to be revised to reflect the digital revolution which occurred and the digital compression of response times. With faster communication, shorter supply lines and leaner inventories, recessions in the future would have to be measured by the decline in GDP rather than the length of the decline.

How profound is the impact of digital deflation? Just measuring quality improvement and productivity increases derived from computers made for final sale, which is less than 1% of the economy, 25% of the rise in productivity from the first half of the 1990s (1.54%) to the second half of the 1990s (2.08%) is attributable to digital quality improvement. Importantly, we are still materially under-reporting digital deflation and significantly over-reporting inflation. It is in the best interests of the investor and the advisor that the government get a better handle on economic policy best suited for the new digital economy. A vibrant economy is the only solution to America’s looming Medicare and Social Security needs. As real mean household income goes up, poverty and the number of welfare recipients goes down. Thus, the economic growth, productivity and deflationary considerations, associated with more accurately reporting digital deflation, are profound.

To make digital deflation more tangible and to weigh its impact within the financial services industry, just consider quality improvement and productivity increases associated with the SEC and the NSCC/DTCC creating standardized protocol that would facilitate the free flow of real-time client permissioned data among custodians, which should occur some time next summer. The associated digital deflation or the permanent improvement in the counsel you provide, would be exponential.

1. The free flow of client permissioned real-time data among all custodians would allow investment recommendations to be made in the context of all a client’s holdings. Thus, it becomes possible for the advisor to determine if their recommendations improved the overall return of all their client’s holdings, reduced their risk or contributed to the tax efficiency, liquidity, cost structure of this client’s portfolio as a whole. Literally, digital technology would make it possible for all advisors to inexpensively make better-informed investment recommendations for any client, where today, that level of counsel is only economically viable to provide at the very high end of the market. What value would the investor ascribe to

going from “it not being economically viable for you to add value for most investors” to it being “economically possible to add value for all investors” with little or no increase in cost? Your increase in value would be exponential. A massive amount of value is “permanently” being added at no additional cost.

2. The free flow of real-time client permissioned data among custodians would establish a real-time work environment that would facilitate the continuous, comprehensive counsel implied by regulatory mandate in order for the advisor to fulfill their fiduciary responsibilities. What percentage of improvement does the client ascribe to an advisor being able to fulfill their fiduciary responsibility versus not. Again, it is a “permanent” exponential increase in the quality and productivity of your counsel.
3. Once the advisor has a free flow of client-permissioned data among custodians, a wide range of web-based, real-time analytical tools are validated and become relevant, which materially elevates the knowledge, understanding, counsel and value added that

the advisor can provide the client in real-time. What percentage of improvement does the client ascribe to real-time attribution analysis? By not having to wait weeks after the end of each quarter for the advisor to know how well each manager they have engaged on their client’s behalf was doing, it becomes far better to act in real-time than reacting when it is too late. Again, there is a “permanent” exponential increase in quality and productivity of your counsel.

We are on the verge of a most profound revitalization of our economy by the assimilation of digital technology across the entire breadth and depth of our economy, which will lead to the greatest creation of wealth in the history of mankind. Economic policy has never been more important nor is the vision and mission of our president ever had more impact. If we can create economic policy that would unleash the unmeasured increases in digital productivity and not impede the forces of the free market from working, we are on the verge of becoming the most dynamic economic engine the world has ever known. ■

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