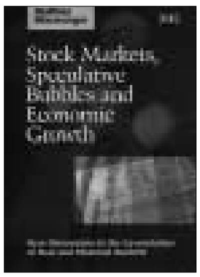
Stock Markets, Speculative Bubbles and Economic Growth: New Dimensions in the Co-evolution of Real and Financial Markets

By Mathias Binswanger, Cheltenham, UK and Northampton, MA: Edward Elgar Publishing, 1999, 368 pp., $110.00 hardcover.



As the U.S. stock market moved into record highs and uncharted waters by any historical valuation measures, a cottage industry has grown up of writing books, mostly by academics, justifying current or higher levels of stock prices or warning of catastrophes ahead. Glassman and Hasset are the most widely quoted of the optimists (*Dow 36,000* by James K. Glassman and Kevin A. Hasset, Times Business, 1999). Not to be outdone, two practitioners (*Dow 40,000*, by David Elias, McGraw Hill, 1999, and *Dow 100,000* by Charles W. Kadlec, New York Institute of Finance, 1999) come up with even higher levels for the Dow-Jones Industrial Average.

Of the three books, the first is the most difficult to believe. The authors contend that the Dow should *currently* be at 36,000 because in the long run (using, say, twenty-year returns) stocks are no riskier than bonds. As Professor Burton Malkiel pointed out in his review of this book in *The Wall Street Journal* of September 22, 1999, the authors argue that the 5.5 percentage point higher return of stocks over bonds in the past seventy-five years is not justified, and stock prices will rise to close the gap. But Malkiel disagrees that stocks are no riskier than bonds. Regardless of age, few investors today are likely to use a twenty-year time horizon! Elias and Kadlec are a bit more believable, because they expect their Dow targets to be reached in 2016 and 2020, respectively, which requires that stocks grow at nine percent and eleven percent a year, respectively, not that much different from historical growth rates.

The cautionary warnings come from Wharton School professor Jeremy J. Siegel, author of *Stocks for the Long Run* (McGraw Hill, 1998), in articles published in *The Wall Street Journal*, and Yale University economist Robert J. Shiller in a new book (*Irrational Exuberance*, Princeton University Press, 2000). Both believe the current markets are seriously overvalued, and Shiller expects a crash followed by a prolonged period of below-average returns.

Lost in this outpour of popular reading is an academic study by Mathias Binswanger, Professor of Economics at the University of Applied Sciences in Olten, Switzerland, containing a theoretical analysis complete with charts and tables, mathematical equations, extensive chapter endnotes and twenty-two pages of references. This three-year study originated in a post-doctoral thesis required in German-speaking countries prior to becoming a university professor.

Binswanger believes that speculative bubbles are an integral part of recent economic development rather than temporary aberrations and that bubble economies are sustainable over extended periods. He argues that a major structural transformation occurred in the U.S. economy in the 1980s in which financial activities now play a crucial role in the development of the economy. The U.S. economy then faced real constraints (a scarcity of new profitable investment projects) because of overcapacities and saturated markets. At the same time, financial markets boomed due to innovations that permitted new financial assets and risk diversification possibilities, leading to a speculative bubble in stock prices, i.e., stock price movements that cannot be explained by subsequent growth in GDP or production. However, declining costs of production due to technological change were accompanied by elimination of excess capacity through buyouts, takeovers and acquisitions, increasing the efficiency of the real sector. Thus the real and financial sectors of the economy are fundamentally interconnected, and bubbles serve a useful purpose.

Throughout the book, the author argues that real constraints and demand constraints (insufficient demand for investment or consumption goods) led to the emergence of speculative bubbles, which were encouraged by developments in the financial markets. These speculative bubbles were sustainable and increased the dynamic efficiency of the economy. These bubbles and higher debt levels also boosted stock prices. While much of the literature emphasizes the destabilizing effects of bubbles, they also have potentially positive functions.

How about the high level of stock prices at the time the book was written (mid-1999)? The author considers the arguments that the markets are not overvalued and rejects them. He concludes that the then-current level of stock prices seemed to be overvalued in terms of fundamentals and can be explained satisfactorily only if you admit the existence of bubbles. In the longer run, "bubbles must move more or less in line with the real economy." It remains to be seen whether this idea will hold true in the present expansion. In any event, the author strongly believes that we should stop interpreting bubbles as temporary anomalies.

This book integrates economic theory and financial markets, with extensive empirical verification that provides much food for thought. The book is not an easy read but gives a more reasoned economic approach to current markets than can be found in the more popular texts cited earlier. The price of the book also is formidable, but perhaps you can find it in your local library or through interlibrary loan. It's worth the effort.

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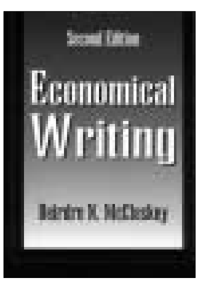
Economical Writing

By Deirdre N. McCloskey, Prospect Heights, IL: Waveland Press, 2000, 98 pp., $8.95 softcover.



Economical Writing is well worth reading. Economists can learn much from this short book (I certainly did), and they can read it in less than two hours.

McCloskey provides very useful advice, not only on style, grammar, and usage, but also on the writing process. As the preceding sentence shows, however, I do not agree with all of McCloskey's suggestions. She urges writers to think hard before using "very," and on page one and again on page eighty-seven, she criticizes the use of "not only . . . but also."

How should one begin a writing task? "Don't wait until the research is done to begin writing," McCloskey advises. "Be writing all the time, working on a page or two here, a section there." Perhaps in anticipation of McCloskey's advice, I composed the last paragraph of this review, not only before I finished reading the book, but even before I started reading it.

In writing an outline, use substantive points, rather than formal ones, McCloskey urges. For example, rather than writing, "Introduction," write, "Housework should be included in national income." McCloskey suggests keeping a dictionary wherever one writes. Moreover, "Only if your computer software has an exceptionally good dictionary, and you can access it more quickly than you can reach over and look up the word can you do without the book."

What should you do after you've finished a first draft? McCloskey stresses the importance of "revising again and again." Any writer, she says, "can learn to delete a quarter of the words from a first draft." She recommends reading out loud as a way to help improve what you've written. "Don't write anything," she says, "that you would be embarrassed to read out loud to the intended audience."

A useful step in revising a first draft, McCloskey says, is to mentally rearrange the order of the words and phrases in every sentence you write. When you're finished revising, the end of the sentence should be "the place of emphasis." Finally, "Never turn in anything to anyone . . . if you haven't spellchecked."

McCloskey offers a wide variety of advice on writing style. It's OK, she says, to violate the elementary-school prohibition against split infinitives. She cautions more than once, though, against "elegant variation"—resorting to synonym after synonym, and especially to poor synonym after poor synonym—to avoid repeating a word. The author gives the example of referring to the "consumer" in one line, to the "household" in the next line, and to the "agent" in the next. (Please note: I substituted "the author" for "she," not for the sake of elegant variation, but rather to help me come closer to the target of 1,000 words that the book review editor gave me.)

The book would be worth reading even if it contained nothing more than McCloskey's admonitions against using the passive voice when you can use the active and against separating modifiers from the words they are supposed to modify. A colleague of mine at AT&T some years ago did an excellent job of expressing the case against the passive voice. Saying "it is hoped," he commented, reflects an unconscious effort to avoid the responsibility that comes with saying, "I hope."

One doesn't have to look far to find violations of McCloskey's rule concerning the proper placement of modifiers. A major newspaper recently reported on page one that "The unemployment rate in November remained level at 4.1%." In fact, "the unemployment rate in November" could not have remained level at 4.1 percent, because the November rate hadn't been 4.1 percent until November 1999. What actually happened is that the unemployment rate remained level at 4.1 percent in November. Similarly, a major magazine recently referred to "the conventional view that growth mainly depends on building up the capital stock." McCloskey, I assume, would have reversed the order of "mainly" and "depends."

The longest of the book's thirty-one chapters (six pages) provides a list of words that good writers should avoid. The list includes "aforementioned" ("what are you writing, a will?"), "interesting" (a word "made weak . . . by its overuse"), and "comprise" ("fancy talk for 'include' or 'consist of'"). I'd go further than McCloskey on "comprise"; I'd say that it is incorrect as a synonym for "consist of."

While there is much to praise in the book, there is also a good deal to criticize. For example, I found this sentence on page sixty-one incomprehensible (the quotation marks and italics are McCloskey's, not mine):

Contrary to what you would think, "the close quote goes *inside* the mark of punctuation, thus."

On pages forty-seven ("Everyone who uses tables or graphs should buy and study Tufte's book, and then reward themselves . . . .") and fifty-three ("Someone less gifted can at least avoid ugly rhythms by listening to what they have written.") McCloskey uses pronouns that don't agree with their antecedents. Finally, on page twenty-one, the author unwittingly provides a textbook example of a dangling modifier: "Once achieved, you can reraise the standards and acquire better doubt at a level of still better taste."

I conclude with a memorable writing suggestion that I received from George Jaszi, who served with distinction for many years as the director of the Bureau of the Economic Analysis of the U.S. Department of Commerce. Twenty-five years ago, in my first writing effort for BEA's *Survey of Current Business*, I referred to a "great increase in unemployment." Jaszi commented, "Reserve the use of 'great' for the nonquantifiable. Lincoln was a great president. Taft was a large president."

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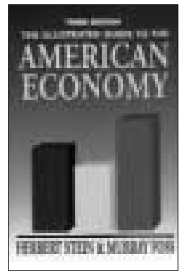
The Illustrated Guide to the American Economy

Third Edition by Herbert Stein and Murray Foss, Washington, DC: The AEI Press, 1999, 283 pp., $19.95 paper.



This book was written "in the belief that talk about the American economy suffered from a lack of information and that an attempt to present some basic facts would be helpful." In 123 well-designed full-page charts with crisp and informative comments on the facing pages, this book provides a comprehensive review of the American economy, its growth and complexity, its good and bad features and the critical issues it faces.

The authors of this excellent volume are well-qualified both to make the observation about a lack of information and to prepare the material to correct it. At the time of his death in 1999, Herbert Stein was a senior fellow of the American Enterprise Institute. From 1969 to 1974, he was a member and later Chairman of the Council of Economic Advisers. He also held positions as A. Willis Robertson Professor of Economics at the University of Virginia and Director of Research for the Committee for Economic Development. Murray Foss is a visiting scholar at the American Enterprise Institute and has been a senior research associate at the National Bureau of Economic Research as well as a senior staff economist in charge of forecasting for the Council of Economic Advisers.

The book is divided into sixteen sections, with four to as many as fifteen charts and comments in each section. The time-series charts, where possible, cover long periods of time to provide historical perspective. The broad areas cover not just U.S. data but also comparisons with other countries. The sections include: the production and distribution of national income; productivity; labor force and employment; income distribution; the structure of the economy; poverty; wealth and debt; economic fluctuations; government expenditures, taxes and deficits; price indexes; health and the quality of life; and the United States in the world economy. The text is written for economists and non-economists alike; and when a topic can be viewed from several different perspectives, they are neatly and impartially presented.

Economists, *even* the most informed, are sure to find information in this book that may alter some previous conceptions. Did you know, for example, since the early 1950s, the business sector has increased in importance, while the government sector has declined? And that farm business accounts for only about one percent of GDP, whereas one hundred years ago it was about twenty-three percent? Or that there is no objective definition of poverty and no objective way of measuring how many people live in poverty? And that there are various ways of measuring income distribution? The reader is sure to find some things in this book that he/she either did not know or were only dimly aware of, and the clear and concise explanations will inform quickly and painlessly.

This book is unlike others that discuss the structure and preparation of various economic time series and their use in economic analysis and forecasting. It is not aimed at the specialist but rather at a more general, intelligent and curious audience that would like a broad overview of the

U.S. economy in easily understood terms. So if you are looking for a small volume as a gift to your non-economist friends, this one is a natural. It will provide material for hours of discussion and debate.

If the book has one weakness, it is the lack of coverage of the financial sector. In the section on wealth and debt, a chart of the Dow-Jones Industrial Average from 1913 to 1998 discusses the stock market as an indicator of the nation's economic health. Ownership of stock, direct and through pension and mutual funds, is also covered. But that is all on the stock market. The fixed-income markets, interest rates and monetary policy are touched on lightly, if at all. Perhaps in a future edition, these issues can be covered more comprehensively in a new section.

This excellent little book should be a useful part of the library of a business economist who often is called on to answer questions outside his area of expertise and is looking for a quick and helpful source of information. The book should be of interest to a non-economist as well. And the factual, impartial, non-polemic nature of the presentation is a welcome relief in this era of controversial and often emotional treatment of important economic issues.

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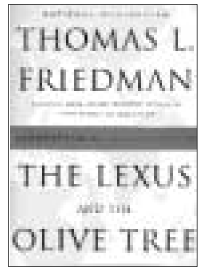
The Lexus and the Olive Tree

By Thomas L. Friedman, New York, NY: Farrar Straus Giroux, 1999, 394 pp $27.50 hardcover, $15.00 paperback (revised and expanded, New York: Anchor/Random House, 2000).



Pulitzer Prize-winning author Tom Friedman, foreign affairs columnist for *The New York Times*, has a way with words and a thought-provoking perspective on the world that few others can match. In his latest book he helps us understand both the opportunities and challenges of today's biggest change—globalization—and the conflicts it creates.

" . . . there I was speeding along at 180 miles an hour on the most modern train in the world, reading this story about the oldest corner of the world. And the thought occurred to me that these Japanese, whose Lexus factory I had just visited and whose train I was riding, were building the greatest luxury car in the world with robots. And over here, on the top of page 3 of the Herald Tribune, the people whom I had lived for so many years with in Beirut and Jerusalem, whom I knew so well, were still fighting over who owned which olive tree. It struck me then that the Lexus and the olive tree were actually pretty good symbols of this post-Cold War era: half the world seemed to be emerging from the Cold War intent on building a better Lexus, dedicated to modernizing, streamlining and privatizing their economies in order to thrive in the system of globalization. And half of the world—sometimes half the same country, sometimes half the same person—was still caught in the fight over who owns which olive tree.

"Olive trees...represent everything that roots us, anchors us, identifies us and locates us in this world. .... The Lexus represents all the burgeoning global markets, financial institutions and computer technologies with which we pursue higher living standards today. Yet, for millions of people in developing countries, the quest for material improvement still involves walking to a well, plowing a field barefoot behind an ox or gathering wood and carrying it on their heads for five miles. These people still upload for a living, not download."

With frequent and compelling examples, Friedman describes the global "electronic herd" that has been created by cell phones, CNN, the internet and the world-wide web of instantaneous, inexpensive global communications. He illustrates how the rapid dissemination of information and the rapid movement of electronic funds by this electronic herd has created a "golden straitjacket" on the ability of national governments and local dictators and bureaucrats to enforce parochial policies without receiving a swift kick in the wallet whenever they try to raise barriers against openness and globalization. Moreover, because of the low cost and widespread availability of information technologies, the electronic herd is now made up not just of "big guys" but also includes a much larger and more diverse number of "little guys" able to vote with their investment dollars. To illustrate this point, he notes that the number of American families with investments in mutual funds has risen from 4.6 million in 1980 to 37 million in 1999. "For the first time in American history both Joe Six-Pack and Billionaire Bob are watching CNBC to see how their shares in the market are faring."

Far from reducing the importance of national and local governments, Friedman sees globalization as making governments very important in somewhat new and different ways. "The ability of an economy to withstand the inevitable ups and downs of the herd depends in large part on the quality of its legal system, financial system and economic management—all matters still under the control of governments and bureaucrats. Chile, Taiwan, Hong Kong and Singapore all survived the economic crises of the 1990s so much better than their neighbors because they had better-quality states running better-quality software and operating systems." Yet he points out that no one country, no one leader or big investor, can control the system. If you want to put a stop to globalization, there is no one you can call on the phone who can bring the process of globalization to a halt. Not the President of the United States, not the chairman of the Federal Reserve Board, not some gnome in Zurich or big investor in London, Berlin or Tokyo. Friedman characterizes this new globally decentralized system with the neologism, "DOScapital 6.0".

This much of the story is not new. Others have said many of the same things, though perhaps less eloquently than Friedman. But Friedman uniquely pulls the thoughts together and adds some important new insights of his own that give a special power to the book. He shows more clearly than anyone before him the conflicts and trade-offs implicit in globalization. "If there is a common denominator that runs through this book it is the notion that *globalization is everything and its opposite.* It can be incredibly empowering and incredibly coercive. It can democratize opportunity and democratize panic. It makes the whales bigger and the minnows stronger.... It enables us to reach into the world as never before and it enables the world to reach into each of us as never before."

Friedman's greatest insight and contribution is perhaps his vision of the new political matrix that has been created by globalization to replace the old liberal-conservative, communist-capitalist framework of the Cold War era. The framework he proposes has four basic political identities that people assume in the new system of globalization, depending on their attitudes about globalization and about income distribution. He divides attitudes toward globalization between "separatists" and "integrationists" on one axis, then he divides attitudes toward income distribution between "let-them-eat-cakers" and "social-safety-netters" on a second perpendicular axis. He illustrates these four basic political positions with specific policy advocates: Dick Gephardt, "separatist social-safety-netter"; Bill Clinton, "integrationist social-safety-netter"; Ross Perot, "separatist let-them-eat-caker"; and Newt Gingrich, "integrationist let-them-eat-caker". These same four positions can be seen today in every politician, in every country. It is the tension between these four positions that will largely drive the major international economic and political battles of the future.

This is an important and well-written book which should be "must" reading for every business economist, businessperson, or government leader who hopes to help guide organizations successfully in the future.

Robert D. Shriner
Shriner-Midland Company
Falls Church, Virginia

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Articles

Facing the Consequences, 8
Implications of Productivity Uncertainty for Monetary Policy, 13
How the Economy Came to Resemble the Model, 16
Economic Foundations and Risk Analysis in Investment Management, 26
Country Risk and Foreign Direct Investments, 33
How Technology Is Reshaping Finance and Risks, 41
Weighing Emerging Market Risk: The Supply of Capital, 52
European Monetary Union: Will it Really Contribute to Stability?, 59
Maintaining the Household Sector with Aggregate Credit Bureau Data, 63

Focus on Statistics

Will the Real Economy Please Stand Up?, 77

Book Reviews, *82*

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