

Bichler, Shimshon; Nitzan, Jonathan

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New Economy or Leveraged Hype?

Shimshon Bichler and Jonathan Nitzan
Jerusalem and Toronto, August 6, 2002

During the 1990s, the conventional wisdom was that the stock market boom was the consequence of a “new”, “high-tech” economy. The high-tech revolution, went the argument, created a productivity miracle and a real investment boom. These two processes generated rapid economic growth and fast increases in profit. And when profit rises, so does the stock market. During the early 2000s, the process went into reverse. The high-tech miracle proved to be a bit of a sham; investment dropped, optimism waned, and the stock market went into a tail spin.

In both cases, the causal link goes from the “real” economy to the “financial” sector. Investors may be looking forward in anticipation, but what they anticipate are “events on the ground” – more production, more growth, more profit. When these real magnitudes are expected to go up, so does the stock market.

Unfortunately, the reality is a bit different. First, the high-tech revolution, assuming there was one, hasn’t created a productivity miracle. Official “measures” of productivity in the United States rose during the 1990s, but the growth remained moderate by historical standards.¹ Business sector output per hour during the 1990s grew by less than 2 per cent annually, compared with 3.5 per cent in the 1950s and 1960s.

Second, capital expenditures indeed rose, but again, when measured as a share of GDP, the increase was hardly exceptional, and fell short of the levels recorded in the 1970s and 1980s. Moreover, in many cases, particularly when green-field investment was ploughed into R&D, the result was massive duplication and waste.

Finally, and as every “rational investor” now knows, the “massive” profit increases of the 1990s owed more to creative accounting than to increased “efficiency.”

Bottom line: profit rose by far less than most people were led to believe, and the increase that did take place had little to do with a “new economy” miracle.

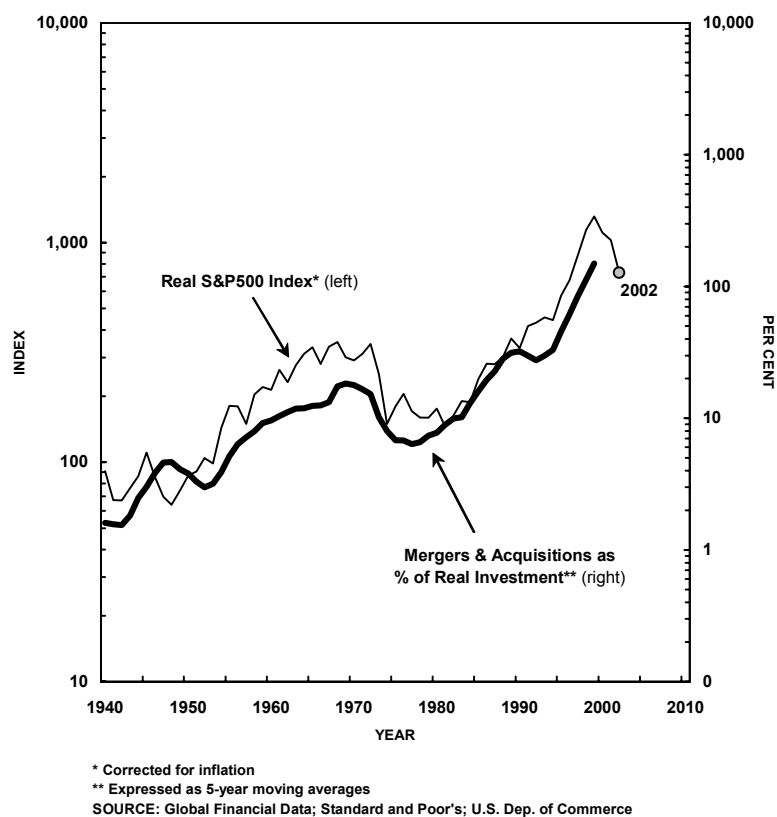
So what lay behind the boom of the 1990s and why did it collapse?

In the United States, the main driver of the stock market since the Second World War has not been the “real” activity of firms (whatever that means), but their financial dealings – particularly mergers and acquisitions.

The process and its impact on stock prices is illustrated in the figure. The chart shows two series. The thick line, plotted against the right-hand scale, expresses the ratio between the value of mergers and acquisitions and the value of investment in new plant and equipment (so-called “real investment”). This ratio rose from 10 per cent in 1940 to nearly 200 per cent in the early 2000s (note the log scale). The thin

¹ The whole idea that aggregate output and productivity can be “measured” is dubious, but that is a matter for another discussion.

Mergers and the U.S. Stock Market



line, plotted against the left-hand scale, expresses the “real” price of the S&P500 index (nominal index deflated by the U.S. CPI).

The correlation between the two series is clear. The stock market boom of the 1950s and 1960s was associated with a massive boom in merger activity (the so-called conglomerate merger wave). In the 1970s, merger activity collapsed and with it went down the stock market. During the 1980s, merger activity resumed, this time on a global scale, and it was this global merger wave, perhaps more than anything, that drove the stock market boom of the 1980s and 1990s.

In 2000, merger activity started to decelerate, and in 2001 it went into a tailspin (official data are not yet available, but anecdotal information confirms the downturn). After twenty years of amalgamation, the number of takeover targets has been significantly reduced, and it will be some time before another merger mania can develop. Until it does, and with all due respect to the “new economy,” the prospect for a stock market boom remains dismal.