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Topical Study #20

**THE COLLAPSE OF COMMUNISM
IS BULLISH**

I. A New Era!

The implications of recent developments in the Soviet Union are enormously positive for the United States. And they are enormously positive for U.S. stocks. Many investment strategists and technicians believe that stock prices are overvalued by most historical norms. They are probably right in the context of the range of historical experiences to which they can refer. However, we believe that the course of recent events in the Soviet Union could make most historical norms irrelevant.

In August 1989, we published a topical study entitled *The Triumph of Capitalism*. The collapse of communism in the Soviet Union in recent days suggests that the struggle between these two antithetical economic systems is over. The struggle has been of epic proportions almost since the day that Marx and Engels published their *Communist Manifesto* in 1848. The Cold War, which had its origins in the Russian Revolution of 1917, came close to becoming a nuclear war during the Cuban Missile Crisis of 1962. The conflict between these two systems caused death and destruction around the globe from Afghanistan to Vietnam.

In the summer 1989 issue of *The National Interest*, Francis Fukuyama, a deputy director of the U.S. State Department's policy planning staff, stirred a great deal of controversy with his article, "The End Of History." He observed that capitalism had triumphed over communism. And he predicted that the end of the ideological struggle could lead to "centuries of boredom." Without the great struggle, human events would lose their ideological excitement and intensity.

Rather than marking the end of history, the Russian Revolution of 1991 probably marks the beginning of a new era. We admit that "New Era" talk is heard most often around tops in bull markets in stocks. On the other hand, we started writing about "New Wave" trends back in 1988 when the Dow was still south of 2000. Here are a number of *new* New Wave trends that now seem much more likely than they did before the three days that shook the world in August:

- 1) The Soviet Union evolves into a loose confederation of 12 republics. This group adopts the model of the European Community. The three Baltic states are also independent and join in an economic union.
- 2) The republics take title to all resources formerly owned by the Soviet government and the Communist Party. Most of these resources are privatized. Laws are enacted to protect private property held by both the republics' citizens as well as foreign investors. The republics adopt their own currencies, which are convertible into all other currencies.
- 3) Foreign multinational corporations move very rapidly to set up bases of operation in the republics. Construction and capital spending booms in the republics generate export booms in the United States, Western Europe, and Japan. The global economic boom expands incomes and generates the financial capital required to rebuild the economies of the 15 former Soviet republics.

4) The competition among the republics for foreign financial capital and direct investments triggers a flurry of "better-than-thy-neighbor" reforms. Each republic passes laws and streamlines government operations in an effort to create a more favorable investment environment for foreigners than exists in the other republics.

5) Most of the republics declare themselves to be nuclear-free zones. The Ukraine has already done so. All nuclear weapons are moved into the Russian Republic. American and Russian negotiators work out a remarkable disarmament treaty that slashes the number of strategic nuclear weapons over the rest of the decade.

6) Saddam Hussein, Muammar Qaddafi, and Fidel Castro are all toppled. Terrorists lose their bases of operation. Syria's Hafez el Assad becomes very cooperative in peace negotiations with Israel. In the Middle East and other trouble spots, the United States, with the cooperation of the Russians, sponsors disarmament talks which are mostly successful in ending regional arms races.

7) The U.S. and European defense budgets are slashed dramatically. There is no longer the threat of a Soviet conventional attack on Western Europe. The Soviet army no longer exists. Instead, each republic has its own military force intended to defend the republic's borders.

8) Some of the peace dividend is given to the former Soviet republics as direct aid and loans. In the U.S., the peace dividend helps to reduce the Federal deficit. The global economic boom and the U.S. export boom eventually eliminate the Federal deficit as revenues soar along with economic growth.

9) Trade frictions between the U.S. and Europe, on one side, and Japan, on the other side, diminish. All three run sizable trade surpluses as exports soar to the former Soviet republics, Eastern Europe, Latin America, and the Middle East. New York, London, Frankfurt, and Tokyo provide the necessary trade credits.

10) Western technology dramatically boosts output of oil and agricultural commodities in the republics.

11) Mikhail Gorbachev accepts a teaching position at Harvard's Kennedy School of Government.

II. The Fall Of The Soviet Empire

At the end of the 1980s, pessimists were predicting that the United States was headed for a fall. They said that Americans were living beyond their means, as evidenced by the "twin deficits." A day of reckoning was coming. There would be a big price to pay for the excesses of the 1980s.

Leading the pack of pessimists was Professor Paul Kennedy of Yale University. In *The Rise And Fall Of The Great Powers*, which was published in 1987, the professor warned that the future prosperity of the United States was threatened

by the country's "imperial overstretch." In his book, which surveys 500 years of history, he demonstrated how other great powers were ruined by this problem.

Great powers fall when their excessive military ambitions sap their economic power base, which, in turn, leads to a decline in their military might and to their downfall as first-rate powers. The Yale historian examines the rise and fall of such great powers as Edwardian England, Bourbon France, and Hapsburg Spain. All of these hegemonies suffered from imperial overstretch. They took on more global obligations than they could afford. They crumbled under the weight of their own empires, usually after long and expensive wars.

The fatal flaw in Kennedy's argument was that the historic examples he presented were all great *empires*. The United States is a great power; it is not an empire. The Soviet Union, on the other hand, was—until last month—the last great empire on this planet. It was this empire that was in decline. Ironically, this fact was becoming apparent just as Kennedy's book soared to the top of the best seller lists. The coup and countercoup of August 19 and August 21, 1991, accelerated the process of imperial collapse.

Today, there is no doubt that the Soviet Union is heading for a fall. The Soviet Union has a population of 290 million people, 40 million more than the United States. Yet by most estimates, the Soviet economy is no bigger than half the size of the American economy—most likely a third as large. The Soviet economy virtually stopped growing in the early 1980s.

During the 1970s and 1980s, the Soviets spent as much as 20% of their GNP on defense. Under Brezhnev, they propped up their puppet regimes in Eastern Europe; they supported unpopular communist dictators and rebels around the world; and they aided the world's terrorists. The Soviets also spent the equivalent of \$100 billion in a ten-year war in Afghanistan. For many years, these expensive imperial activities were financed with revenues from oil exports. When oil prices collapsed in the mid-1980s, the Soviets quickly ran out of money to finance their imperial activities.

Unlike the Soviet Union and the other great powers that eventually declined, the United States is not a colonial power. Moreover, the country spent only 6.6% of its GNP on military outlays during the 1980s. Now that the Soviet empire is crumbling, this percentage will be even lower in the 1990s. America's economic power base is growing: Real GNP rose 30%, and employment expanded by almost 20 million over the past decade.

The Cold War came to an end in 1989. The countries of Eastern Europe were all liberated from the Soviet Empire in 1990. In 1991, the Soviet Empire ceased to exist. The Soviet Union, not the United States, suffered from imperial overstretch.

III. The Triumph Of Free Trade

The spectacular failure of communism in the Soviet Union brings into much sharper focus the extraordinary success of capitalism in the West. The communist system of central planning destroyed economic incentives. It wasted

economic resources and polluted the environment beyond comprehension. The Soviet economy would have started to decline in the 1970s but for the sharp jump in oil prices. The collapse in oil prices during the 1980s removed this temporary support and the economy crashed.

As a counterexample, the idiotic Soviet experiment of the past 74 years also demonstrates the benefits of free trade. Closed off from engaging in free trade with the West, the Soviets fell behind to the point that their economy could no longer support the country's burdensome military budget. Of course, no country is more closed off to free trade than is Communist China. Virtually all of that nation's people live in conditions of pre-industrial poverty.

IV. Free At Last

The collapse of the Soviet Empire promises to bring freedom, free markets, and free trade to 15 Soviet republics and 7 Eastern European nations. That's a total of 414 million people.

In the European Community, 340 million people are moving toward the 1992 free trade zone. The countries of the European Free Trade Association are seeking closer ties with the EC, and the two organizations have a combined population of 372 million.

In North America, 360 million people are also likely to be joined in a free trade zone by the middle of the decade. Undoubtedly, the North American bloc will evolve into an all-Americas zone encompassing 700 million people by the beginning of the 21st Century.

Add another 210 million in Japan, Australia, and the newly industrialized countries of East Asia. The total number of people that are either free or likely to move in that direction is nearly 1.7 billion!

V. What's Wrong With This Picture?

Plenty can still go wrong, of course. You don't need us to remind you of that or to make a list of the problems.

It would be ironic indeed if capitalism now failed. Some economists predict that a depression is imminent in the United States. They say that the Federal Reserve is pushing on a string.

It is claimed that lower interest rates will not sustain the present recovery. Instead, the weight of all the loans made in the 1980s, which are turning bad in the 1990s, will drag the economy back down. At the very best, growth will be sub-par during the current decade. At the worst, the experience of the 1930s will be replayed in the 1990s.

In 1985, we studied the depression of the 1930s in some detail. Our conclusion, which we admit is controversial, was that the Great Depression was caused by the Smoot-Hawley Tariff of June 1930. World trade collapsed

and so did most industrial economies. We don't believe that the Depression was caused by the problems in the U.S. monetary and banking systems.

Therefore, we predict that the current problems in the American credit system will not result in a depression. Unlike the 1930s, the global trading system is moving toward fewer barriers and lower tariffs. In the unlikely event that this trend is reversed and the world economy is strangled by protectionism of the 1930s vintage, then we would worry about a depression.

Pessimism about America's future has been in fashion for many years now. The forces of darkness have not been vanquished entirely. But don't underestimate the forces of light: The big picture is very bright.

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- #15 Dr. Edward Yardeni and David Moss, *The New Wave Manifesto*, October 5, 1988
- #16 Dr. Edward Yardeni with Amalia Quintana, *The Baby Boom Chart Book*, January 25, 1989
- #17 Dr. Edward Yardeni, *The Triumph Of Capitalism*, August 1, 1989
- #18 Dr. Edward Yardeni and Deborah Johnson, *Dow 5000*, May 9, 1990
- #19 Dr. Edward Yardeni and David Moss, *The Triumph Of Adam Smith*, July 17, 1990

* Out of print.