Foreign Exchange by David Goldman

How overvalued is the dollar?

A new study shows that United States securities are vastly inflated.

Contrary to Adam Smith's slanders, the great mercantilist Colbert did not seek a trade surplus for the pleasure of accumulating bullion reserves, but because a country's capacity to export a net portion of its product was, and is, an excellent rule-of-thumb measure of its capacity to produce a surplus of physical goods, over and above maintenance costs.

By the old mercantilist standard, America's nearly $200 billion per annum chronic trade deficit demonstrates that the entire economy is running at a net loss in physical-goods terms.

That seems to jar with the tripling of the price of U.S. equities since August 1982. But as *EIR* reported recently ("Italian banker forecasts the end of the great bubble," Aug. 28, 1987), the supposed earnings boom underlying the stock market is entirely illusory. Deduct unreserved losses of financial institutions, increases in the paper value of corporate real-estate holdings, and related categories, and U.S. corporate earnings evaporate. Retailers' $58 billion profit, the largest single component of corporate profits, makes the point: retailers buy cheap goods abroad, particularly in Third World markets, at a third their home-production costs, and sell them at home prices. The biggest component of U.S. corporate profits on paper actually reflects the collapse of the home economy's profitability in physical terms!

Now, the Tokyo branch of S.G. Warburg, the British investment bank, has published a remarkable study, deflating American corporate earnings to match much more stringent Japanese standards. The result: Supposedly overvalued Tokyo stocks are still much cheaper than American equities. *EIR* has not proofed Warburg's results, and is suspicious of the firm's investment recommendations; but the study nonetheless sheds light on the hoax behind the New York stock bubble.

Analyst Andrew Smithers simply recalculated the price-earnings ratios for the New York, London, and Tokyo stocks markets, after adjusting for accounting differences which change the definition of "earnings." To start with, Japanese firms function like investment trusts, that is, they own substantial shares in each other. "Almost exactly half the shares quoted on the Tokyo Stock Exchange are beneficially owned by other quoted companies," he writes. But the dividends which companies receive from their shareholdings in other companies are not counted in their earnings as reported to shareholders.

Much more significant in the recalculation earnings than this form of underreporting, however, is the difference in rates of depreciation in Japan. Japanese companies, encouraged by a tax code that gives generous advantages to new capital investment, write off the value of their capital equipment much faster than American companies—in some cases, three times as fast. Faster depreciation of capital goods cuts into short-term profits—because the write-down of old equipment's value comes straight out of earnings—but it contributes to future profits, by clearing the way for investment in newer and better technology.

In fact, the rate of depreciation corresponds closely to an economy's profitability in physical terms: A growing economy will replace its capital stock more quickly, writing down the value of the old junk as fast as possible. America's 1986 tax "reform" went in precisely the opposite direction, eliminating about $25 billion a year in depreciation of capital goods for tax purposes.

Warburg's study threw out American companies' dubious bookkeeping methods, and looked at the price of shares on the basis of *cash* earnings, eliminating the difference in depreciation methods. The remarkable result, after all the adjustments, shows the average price-earnings ratio in the Tokyo stock market at only 8.3, lower than Britain's 10.3 and Wall Street's 9.0.

Nominally, the price/earnings ratio of the Tokyo stock market as a whole at the end of June stood at 58.2. That has led to talk of a Japanese stock-market crash from supposedly dizzy levels of speculation. Foreigners have been liquidating Japanese shares; they sold $26.3 billion last year. Meanwhile, foreign companies invested $25 billion in the U.S. market in 1986. So far this year, British companies alone have bought $22 billion of U.S. stocks, against $13.6 billion last year.

Whether Japanese shares are overvalued or not, *EIR* will not guess. However, the apparent overvaluation relative to the American market, a source of cheer to bull-market prognosticators, is strictly a function of phony bookkeeping in the American corporate sector.