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REAL MONEY
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It is rare to have the chance to see major structural changes occurring in not one, but two of the world's major economies – in this case, Germany and Japan. In my opinion, these changes will provide, in one case, a major investment opportunity and in the other, a major challenge over the next decade for those who enter these markets.

For almost a decade now, Japan has avoided the stiff measures needed to help its economy. Unfortunately, I think it may still take several more years for Japan to implement the sharp measures needed to heal that country's economy. Even with the help of its recently elected government, whose stated mission is to jumpstart the moribund Japanese economy, the inertia generated by "old guard" bureaucrats is likely to hamper the effectiveness of any program put forth by Japan's leaders. Recent economic news from Japan shows it will hardly grow at all in 2001. Current interest rates being paid by Japanese banks hover around 0% to 1%. What will it take to move Japan into a growth mode?

One of the most serious unresolved issues is bad debt on the books at major Japanese banks. The U.S. savings and loan crisis of the 1980's threatened to pull down the entire U.S. financial system, but regulators and the use of market mechanisms allowed most problem institutions in our system to sell or write off the bad loans and then close poorly managed facilities. The US economy was therefore able to overcome the crisis and recover within two short but painful years. When evaluating Japanese companies on traditional criteria such as price to earnings ratios, they still have room for major moves to the downside.

Unfortunately, Japan has neither the stamina nor political will to face the music of layoffs and plant closings. Instead, it has relied on taxpayers' money for infrastructure projects, spending more per capita than any other industrial country in the world. This has crowded out the private sector, in particular new businesses being started by a new generation of entrepreneurs, making it difficult for more innovative younger companies to get the capital necessary to grow a business. Is Japan going to face up to its problems? The new minister, Mr. Koisumi, is considering having banks deal forthrightly with their worst loans, but not for two or three years from now! He wants to privatize some public enterprises, like the postal system, which plays the strange role of "holding tank" for much of people's cash in Japan. However, none of the prime minister's plans give specific target dates, which is why I don't have much faith that they will actually be implemented.

What a contrast this is to the news coming out of Germany! Intensifying foreign competition and the elimination of a long-standing capital gains tax next year are forcing Germany's banks and insurers to undo fifty-years of corporate cronyism. Since WWII, banks, insurance companies and industrial companies in Germany were allowed to serve on each other's boards of directors and protect each other's turf. This practice provided much needed stability and secure employment for a majority of German working people, a program that now faces an uncertain future.

One of Germany's largest banks recently gave instructions to its client companies (which are both customers and shareholders) to cut 20% of their work force immediately and look hard for other cost-saving measures. This is reminiscent of the early 1980s in corporate America. The German economy used to be concerned primarily with producing high-quality products, second with treating employees well, and only then with taking care of shareholders. This is about to change.

It is well known that the German economy is slowing, mostly due to the United States recession that has negatively impacted German companies volume of exports, and also declining domestic demand. Unemployment in Germany is at 9.3%, with many companies predicting more lay-offs. Germans tend to be much more cautious than Americans in their spending habits, with the average German household debt at approximately one third that of the typical American household. The new German capital gains tax will provide an incentive for corporate leaders to take an "Americanized" view of their firms, focusing on the bottom line with the intention to increase shareholder value. In addition, landmark legislation regarding German retirement plans that was passed recently will create a reason for the public to take a more active interest and participate in their own stock market.

At the present time, only 10% of Germans own stock, compared with approximately 50% of Americans. The new laws will create private retirement plans, much like our 401(K) plans, that will encourage the working- and middle-class to acquire stock positions in domestic companies. At the same time, many formerly government-owned monoliths are turning away from their traditional source of financing, banks and insurance companies and towards more market-driven sources of capital that are both less expensive and more flexible. This is the underpinning of a thriving German bond market, which has heretofore been concentrated on government debt and not issues created by private companies.

In the words of one German industry chief, "Tax reform has removed all the excuses for preserving the status quo." This reflects a change in worldview and portends a shift in the economy and a potential stock market turn-around. What does this mean for investors looking to put some of their money overseas? Germany may undergo the kind of rapid change seen in the United States in the 1980s when "Reaganomics" took hold and social quality control was replaced by faith in market forces. For Germans, the expectation of lifetime employment may soon fade. There was a joke in Germany that shareholders were to be treated like mushrooms -- kept in the dark and thrown a little fertilizer now and again. The reversal from social safety net to capitalistic entrepreneurs will hurt people at the bottom of the education scale but benefit investors in the German stock market.

Unions will be the biggest losers in these changes. Their members will have to work just as hard for lower pay with less security, a very difficult political maneuver. There is likely to be a lot of unrest since the German system allows for and tolerates active demonstrations by union members.

Germans realize that the financial underpinnings of their society are changing rapidly. Many of these changes have their roots in the early 1990s when the West Germans came close to overspending the collective accumulated capital stock on the reintegration of their much poorer brethren in the East. As a result of increased internal and international competition, many jobs in industries where the unions were strong and well organized are disappearing, and the new jobs being created are in the service sector, where union power is weak. This should sound familiar to students of the American labor movement.

Dealing with change is something most Americans have gotten used to. I believe that Germany will be the first country in Europe to trade off a widespread social entitlement system in exchange for increased opportunities for individual advancement and wealth creation. There is a commitment in Germany to give incentives to companies and individuals willing to become involved in the capital markets.

These changes will be difficult for some Germans and wrenching for much of the German social system. If successfully implemented, the growth in German stock prices over the next ten years may be similar to what we saw during the bull market of the 1980's and 1990's here in the United States. This will bring new wealth to the German economy but it will most likely be concentrated in the hands of those who see the signs of these opportunities and who move to participate in the equity markets there.

Rob Rikoon is President and CEO of Rikoon-Carret Investment Advisors, New Mexico's largest independent money manager for individuals, families, and non-profit organizations. He can be reached at rrikoon@aol.com or at 989-3581. Rikoon-Carret is hosting a seminar on the US and international stock and bond markets on Wednesday, August 29th at 2 pm and 6 pm and on Thursday, August 30th at 3 pm (advanced reservations are suggested).