

Issues After The Election

A Hoppie Looks Back

Introduction

“And I have led you forty years in the wilderness: Your clothes are not waxen old upon you, and thy shoe is not waxen old upon thy foot”

Deuteronomy 29:5

Forty Years

- Children of a lesser God? No, children of The Greatest Generation
- The Class of 1975, matriculating in 1971, was standing on the cusp of some very large changes, many of which we are still trying to resolve today
- Success often is harder to manage than mediocrity
- As Captain America said in 1969's *Easy Rider*, "We blew it"

Who Won And What For?

- The largest political party in the U.S. is not the Democrats nor the Republicans nor third parties/independents
- It is the Right All of the Time party
- This is a natural outgrowth of the polarizing issues from more than forty years ago combined with the unforeseen consequences of modern technology
 - In a world where anyone can address everyone at near-zero marginal cost, we tend to seek like-minded people in conversation
 - The net result is the edge of each opinion cluster dominates group thought and mandates delegitimization of others

The World At The Time

- Our world at the time had two issues seen as having morally right and wrong sides, the Vietnam War and the civil rights issue
 - Those who were on the “right” side of those issues had to be right elsewhere as those on the wrong side were, by definition, prone to evil
 - Key issue clusters formed around these:
 - Attitudes toward environmentalism, etc, were easy to assess if you knew where the person stood on the defining core issues
- Other, more orthogonal divisions, such as statism or corporatism, were ignored
 - Google “Pournelle chart”

World At The Time (Cont.)

- Key socioeconomic issues came to the fore
 - The National Environmental Policy Act of 1969 internalized the costs associated with economic activity
 - Inflation associated with the costs of the Vietnam War led to the
 - Closure of the gold window
 - Fragmentation of the Bretton Woods system of fixed-exchange rates and the beginning of the long slide in the dollar's purchasing power
 - Present overt politicization of monetary policy
 - The first energy shock of 1973-1974 threatened American psychic well-being in a primal way and apparently permanent way
 - Bailouts of too-big-to-fail corporations such as Penn Central and Lockheed were the first salvos in modern crony capitalism

World At The Time (Cont., 2)

- Although the phrase had not been invented yet, the Empire Struck Back...on both sides
 - The 1972 election started the split of the big-tent Democratic party into a dominant left wing and ultimately to its abandonment by what was later termed Reagan Democrats
 - The identification of more statist Democrats with the civil rights issue led to the migration of the South to the Republican party
 - Ultimately, the two coalition parties became today's ideological and non-compromising parties...both comprised of those who are Right All the Time
 - The 1972 election produced the Watergate affair, both an extremely divisive and highly corrosive issue. Ad hominem politics, always extant, was taken to a new level and stayed there

World At The Time (Cont., 3)

- The combination of a weakened Nixon and a Democratic Congress led to the passage of the Budget and Impoundment Control Act of 1974
- This is when Congress started to abandon the formal passage of a budget and slide into a series of continuing budget resolutions, stopgap appropriations and midnight amendments
- Regardless of party control, the enterprise of the federal government is not managed very well
 - We just had an election and are in mid-November. What will tax rates be come January 1, 2013?

World At The Time (Cont., 4)

- The demographic time-bomb was known. We took the opportunity to improve the fuse
 - Anyone 62 today was 22 in 1972 when Social Security recipients were given a 20% COLA and the COLA adjustment was set to the CPI plus 1%
 - Franklin Roosevelt would have understood: “No damn politician can ever scrap my social security program”
 - The principles were set both here and in Medicare/Medicaid to increase present benefits and defer costs
 - ERISA would be passed in 1974
 - All defined-benefit pension plans, public and private, faced the calculus of the federal “entitlements.” The private sector has moved to defined-contribution; the unionized public sector with its monopolistic labor and monopsonistic buyer has not

The World At The Time (Cont., 5)

- The nomination processes of 1968, in particular Hubert Humphrey's selection by party insiders, led to the McGovern reforms
 - These involved a profusion of primaries and by the 1976 election led to a two-year campaign for the Presidency
 - McGovern himself was the first beneficiary of a process that rewarded those on the flanks of the major parties
- The end of big-tent intraparty coalition-building led to the polarized situation seen today
- When combined with gerrymandered districts and a similar process of local-office primaries, the result has been a penalty for statesmanship

The Context

Economic losses are created by misallocation of resources during a bubble. We simply do the accounting after the bubble bursts.

Writing yourself a check and saying, "I'm rich!" is more a sign of a mental disorder than of an economic policy

Debt And Wealth

Let's define wealth as the capacity to consume

- In an agrarian society, wealth is capped by very narrow consumption limits, by extreme risk levels and by the difficulties producers have in capturing their own economic surplus. The value-added proposition for a commodity producer is low
- In an industrial society, the capacity to consume climbs markedly as new and improved goods are introduced and as a replacement cycle begins. A high degree of value-added is possible, and both the producers and the labor involved can accumulate capital with the assistance of the financial system
 - For the first time, a large middle class can be created as industrial organizations both demand and can reward a large and relatively undifferentiated pool of workers, both blue- and white-collar

Debt And Wealth (Cont.)

A historically freakish perfect storm led to an unprecedented accumulation of wealth in the U.S.:

- Large-scale imports of motivated human capital
- Ability to exploit open land and new resources; this is putting aside any and all value judgments as to this process
- The legacy of the common law system protecting property rights
- The relative absence of a caste system
- The absence of large-scale destruction from war
- The close-in-time revolutions in transportation (railroads), communications (telegraph) and energy (fossil fuels in general, petroleum in particular)

Debt And Wealth (Cont., 2)

- These factors combined during the first half of the 20th Century to create a fantastic imbalance of wealth, financial power and military power; they were occurring while much of the world destroyed itself in war, misguided politico-economic experiments and the legacy of illiberal political systems
- The second half of the 20th Century saw this reverse. As Asian economies, first Japan and later China, came to the fore, the longstanding competitive advantages in production enjoyed in the West started to erode
- Asian mercantilism was content to finance Western consumption, and Western societies were content to consume as if the wealth was generated internally

Debt And Wealth (Cont., 3)

A second perfect storm was underway

- The move toward a post-industrial and information-based economy led to an unprecedented revolution in global factor mobility
 - The capacity to consume information is virtually unbounded and the marginal cost of production of information can decline exponentially faster than its marginal return to society
 - Information producers can capture much of their surplus in hardware/software and almost none of it in content
- A decision made by all societies as they become wealthier, to stop living in their own filth, raised production costs just as a pool of cheaper labor was becoming integrated into the global economy. Production moved to low-cost pollution havens

Debt And Wealth (Cont. 4)

Western societies had convinced themselves of their entitlement to this standard of living and indeed had longstanding intellectual justifications going back into the late 19th Century and Bismarck's first social insurance programs therefor

- These changes in the social compact were intended originally to defuse militant labor movements
- The social compact changed further during the Great Depression and the aftermath of World War II
- Often and erroneously labeled “Keynesianism,” the notion governments and later central banks had an obligation to manage the economy devolved in practice to public spending biased toward deficits and monetary policy biased toward inflation, all done with the notion this would preserve wealth

Our Social Compact

- Australian aborigines had their Dream Time as part of their origination mythology
- We have something called Retirement as part of our life-beyond mythology
 - You would go to school, get a job, start saving and then end your years wasting away in this homage to Margaritaville
 - The investment myth was sold to the extent corporations could be said to exist to provide returns to finance this dream
 - The focus of public policy turned toward paving the way in the form of tax preferences, pension protections and above all, “entitlement” programs
- Never mind the unreality of the promises implied

The Compact's Corollary

- The Dow Jones Industrials first closed over 1,000 on Tuesday, November 14, 1972... nearly forty years ago to the day
 - It would take another ten years, until October 1982, to put this nominal level in the rearview mirror
- The near-tripling of equity values by August 1987 combined with those defined-contribution plans to make investing a popular participation sport
- The October 1987 crash led to
 - Asymmetric restrictions on stock market movements over and above artifices such as the “uptick rule”
 - The “Greenspan put”

The Corollary (Cont.)

- We had entered an era where one of the primary responsibilities of the government would be to assure people the stock market would not go lower
- This reached its zenith in 2008 and has remained there
- We learned during the financial crisis our ability to consume – our wealth – was tied to the stock market in ways we had not realized
 - This included underfunded pension plans and endowments, including university endowments
- The stated purpose of QE2 in November 2010 was to create an equity-based wealth effect

Politics And Wealth

Fiscal Policy

- The political interpretation of Keynesianism has been for contra-cyclical deficits
 - Never mind contra-cyclical surpluses; the one period of surplus since the 1970s occurred in the late 1990s when increased FICA “contributions” were borrowed by the general fund
- The U.S. has shifted away from a broad-based income tax to a narrow-based and very progressive income tax that makes revenue dependent on those who
 - Can shift/defer/offset income
 - Influence elections via “contributions” of their own
 - Have variable incomes related to capital gains that make tax bases highly volatile; see California

Fiscal Policy (Cont.)

- Fiscal policy is in bad odor. Consider:
 - The American Recovery & Reinvestment Act of 2009 succeeded largely only in staving off state & local bankruptcies via two-year payments and the Build America Bonds program
 - The effects on output and employment were poor, and no one should be surprised unless they think we still build things by hand and years of regulatory encumbrances allow for “shovel-ready” projects
- A democracy becomes unstable when a near-majority does not have to bear the marginal costs of government
 - Marginal rate reductions for those with a high propensity to invest are difficult when those same people constitute the tax base

Fiscal Policy (Cont., 2)

- A lack of economic literacy drives policies that lead to higher demand, capture of the economic rent by suppliers and masking of direct costs
 - Education and healthcare are the prime examples here:
 - Increased availability of student loans have led to the hideous situation of ballooning student debt; the impulse to increase funding availability should be resisted at all costs and yet was proposed by both major parties
 - ObamaCare perpetuates indirect payment of healthcare costs and therefore will lead to a continuing price spiral and rationing via time and other costs
 - The post-2008 mortgage subsidies and tax credits were captured by the sellers

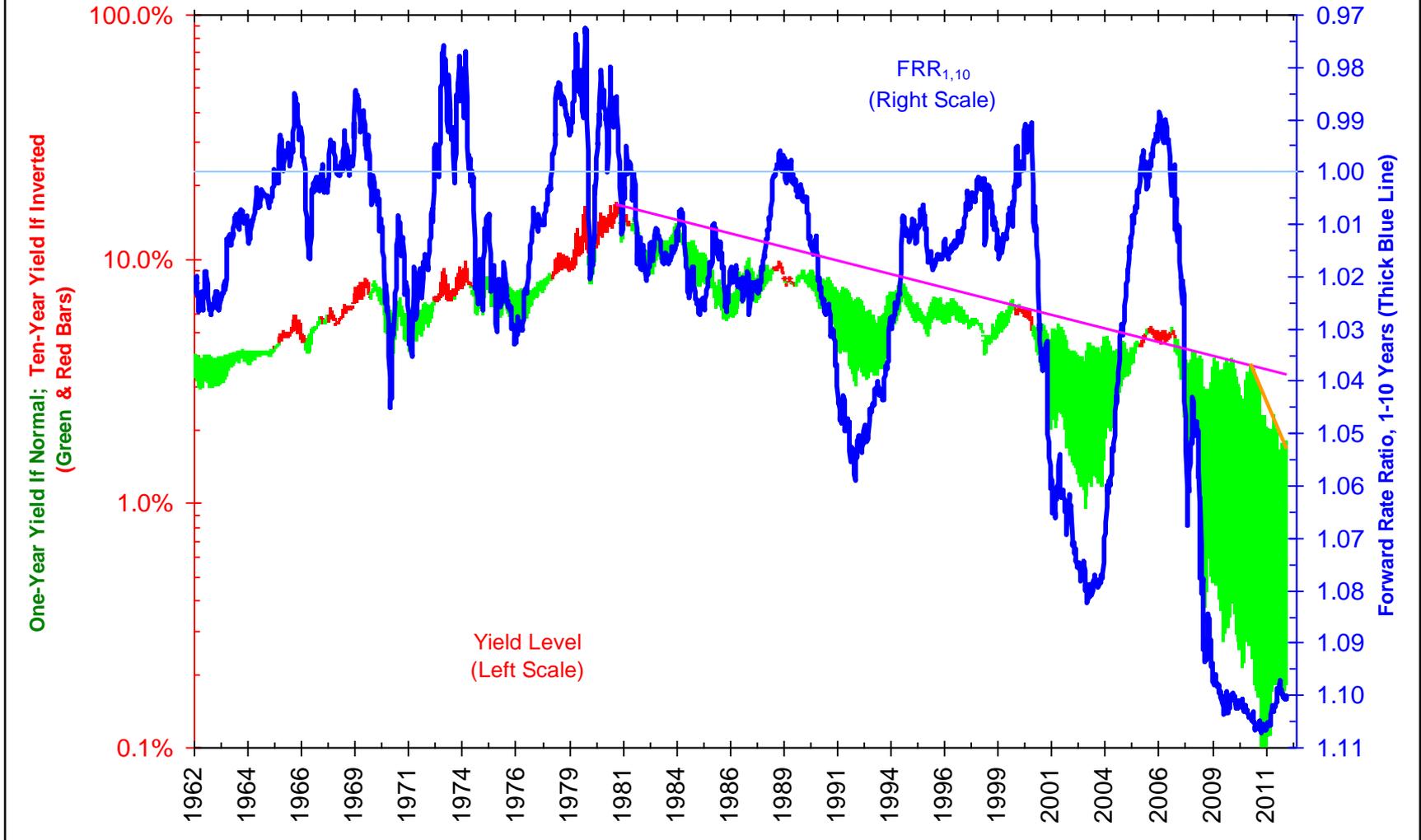
Monetary Policy

- Milton Friedman famously said monetary policy operated with long and variable lags. This was a kind way of saying we do not know what will happen or when, and yet we continue to ascribe deterministic outcomes to monetary policy
- The convenience is the Federal Reserve is unelected
- Interest rates equilibrate the demand for future consumption with the demand for present consumption
 - Lower interest rates shift future consumption into the present
 - They also reduce/penalize saving and therefore reduce investment

Monetary Policy (Cont.)

- Monetary policy runs aground on rational expectations
 - If markets perceive a policy to be temporary, decisions will not be based on the present artificial conditions
- The course of monetary policy over the past three decades has been to steepen the yield curve at ever-lower interest rates on the belief rewarding the borrower and penalizing the lender is stimulative
 - Not only are savers penalized, the present value of defined-benefit pension plans increases while the ability to earn a return at “prudent” risk declines
- Who is the greatest borrower and therefore the primary beneficiary of this policy?

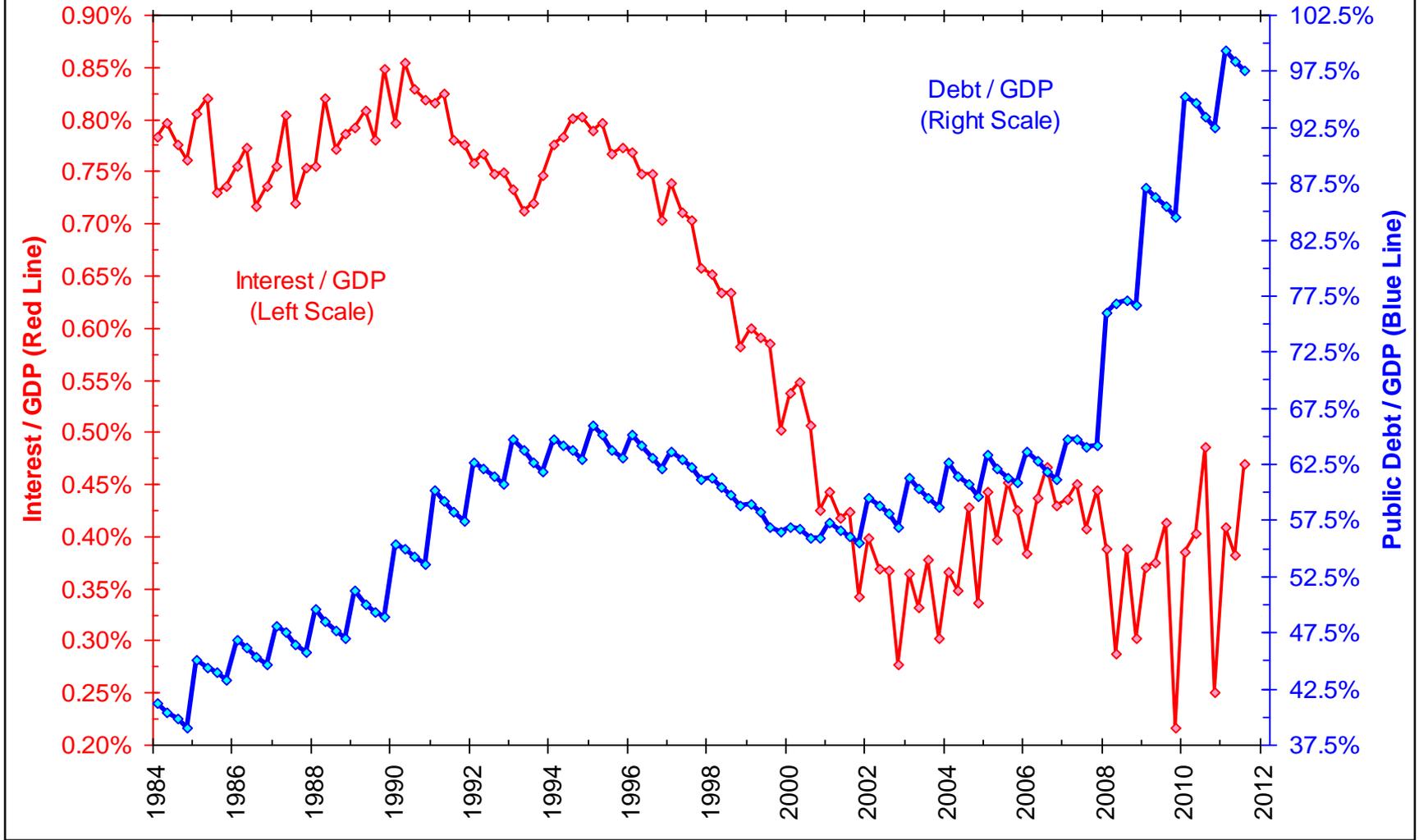
The Yield Curve And Yield Levels



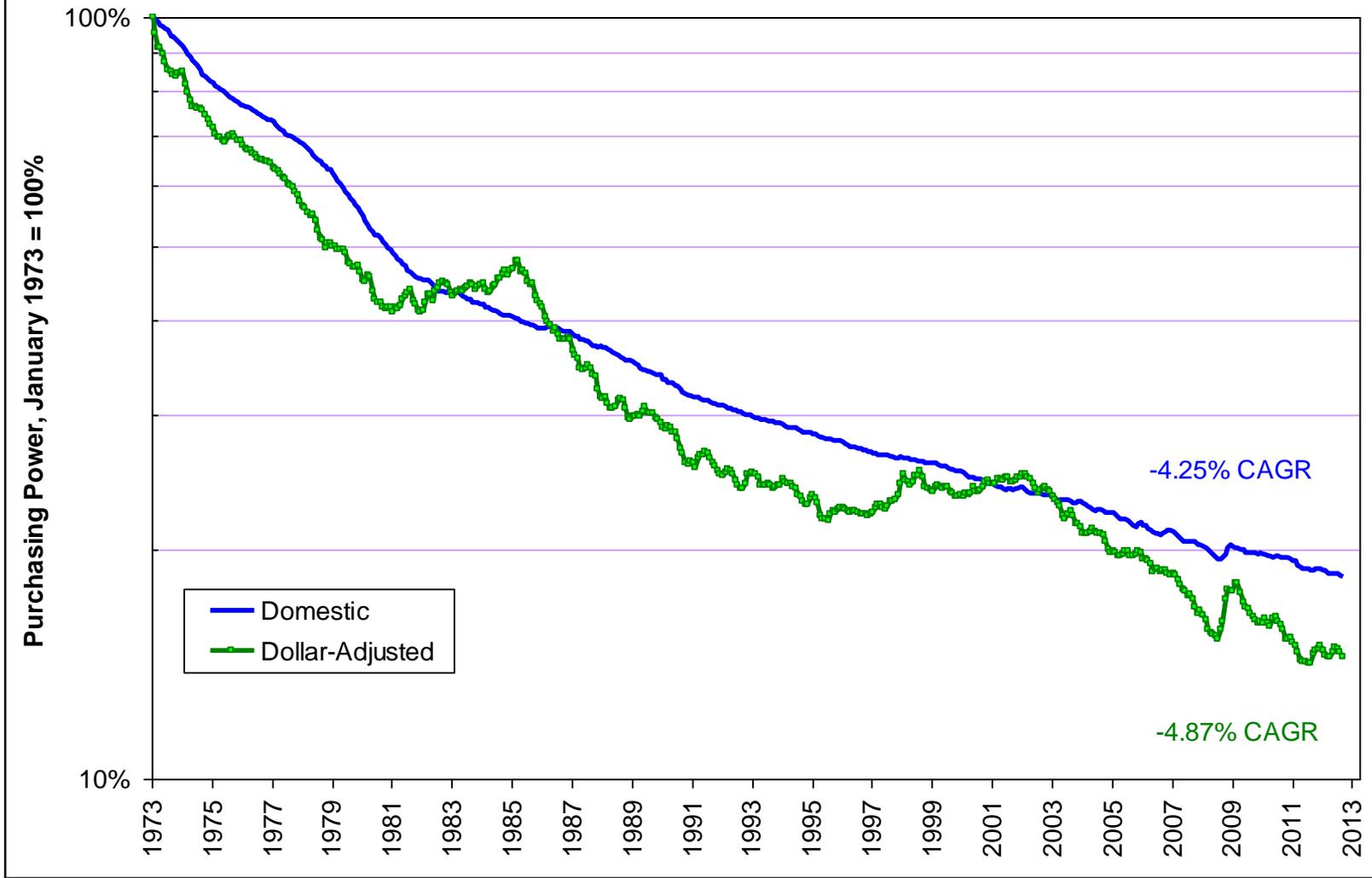
Monetary Policy (Cont.)

- The paradox is federal debt service costs as a percentage of GDP have remained manageable even as debt/GDP ratios have increased
 - This has been a “flight to the printing press” and has resulted in the absurdity of negative real Treasury yields
 - Frightened investors are paying the federal government here and other governments elsewhere to lend them money
- A borrower that can go \$1 trillion further into debt at a service cost of \$10 billion and then have the central bank print the \$10 billion has little incentive to correct its policies
 - Or, as the recent election showed, even discuss them much

Debt Service And Public Debt



The One Constant In American Life



Conclusions

- You get the government you deserve; as Mencken said, “good and hard”
- The issues and policies from forty years ago are embedded without proposed solution today
- The likely stopgap will be a surprise package out of the lame-duck Congress done with the accountability of the Illinois General Assembly at the 2010/2011 turn
- The path of least resistance for all involved will be more of the same until the next crisis
- No consensus exists as none is possible when you are Right All the Time and others have nothing to say