The End of the Reagan Boom & the Slide to the Great Recession:

Causes, Consequences, Remedies

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Agenda

Current status of the U.S. economy: some data to highlight the challenges

A brief look at history: what are the institutional conditions that promote strong and sustainable growth?

Post-war economic growth in the U.S.: with a focus on the seminal moment of August 15, 1971 to today

2000s story is in two parts:

-- George W. Bush diverged significantly from Reagan

-- Five major policy errors lead to catastrophe

Questions and discussion, focusing on two themes:

-- What is the best policy mix moving forward?

-- How can we effectively communicate this?

What is 2012 all about? The challenge to grow

Economic growth does not solve all problems, but it does solve most of them!

The difference between an economy growing at 3.3%, 2.4%, and 1.7% per annum is staggering over the long haul

$24.4 trillion economy in 2027

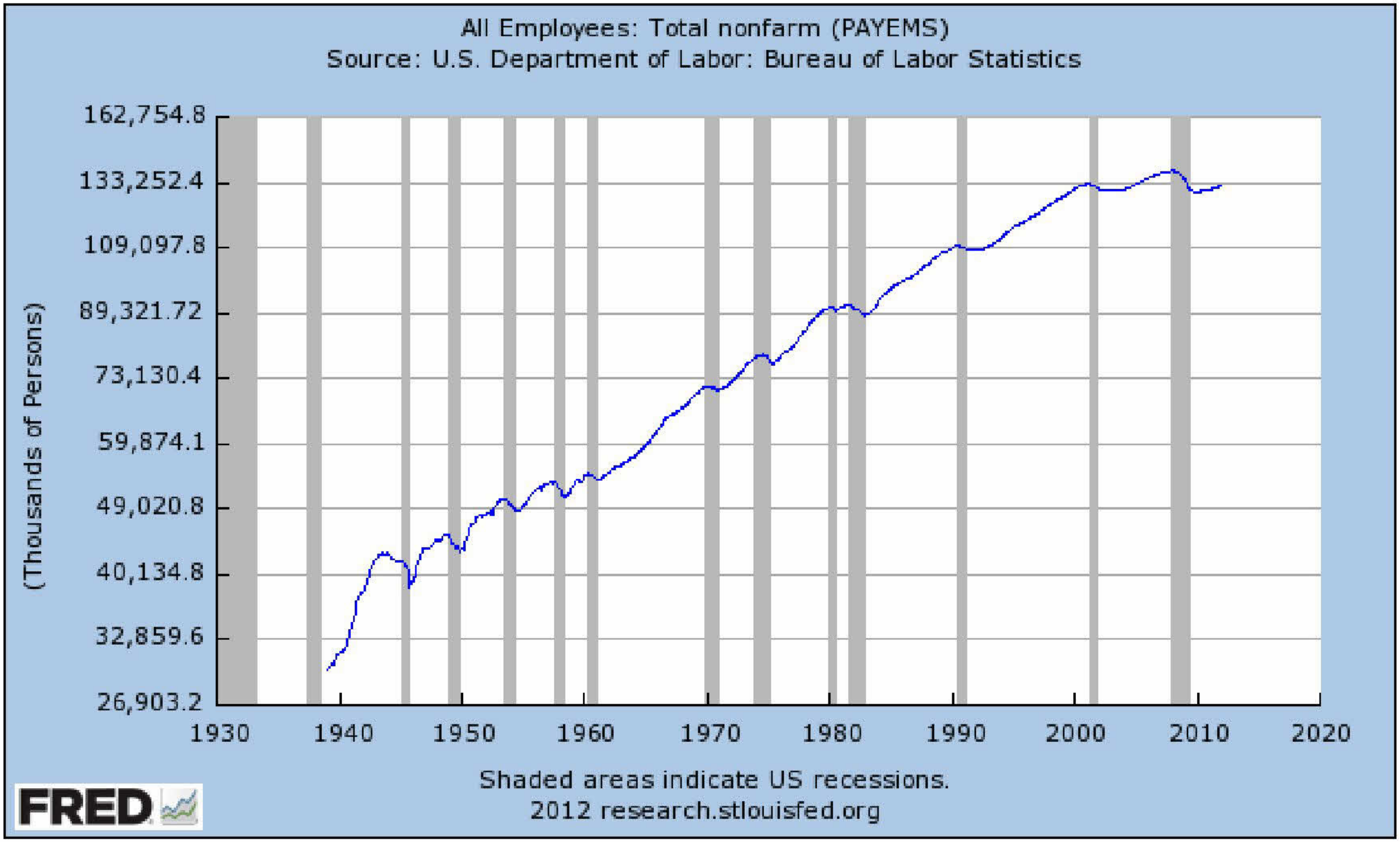
$21 trillion economy in 2027

$19.6 trillion economy in 2027

$15 trillion economy in 2012

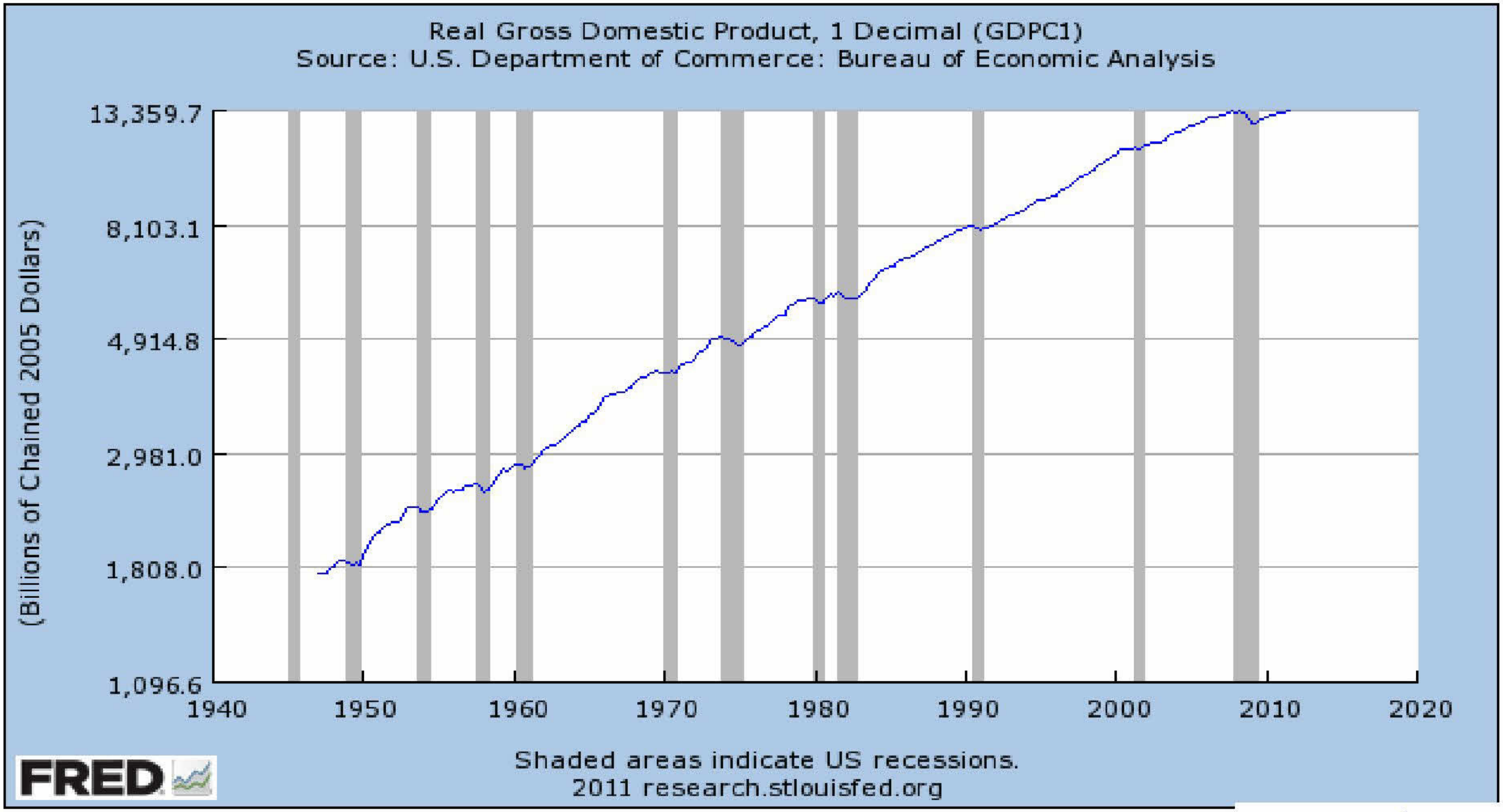
Total Nonfarm U.S. Employment Since 1939

Note lack of job growth in last 12 years; worst since 1930s. We are way off-trend now (this is a log-scale), though note trend recovery in '80s and '90s



U.S. GDP Growth Since 1947 (log scale, in 2005 dollars)

Key points: Notice the long term graph; does policy matter, after all? Also, note how far off-trend we are now; it took four years to get to 2007 GDP level. Note recoveryto trend in 1983. Can that happen this time?



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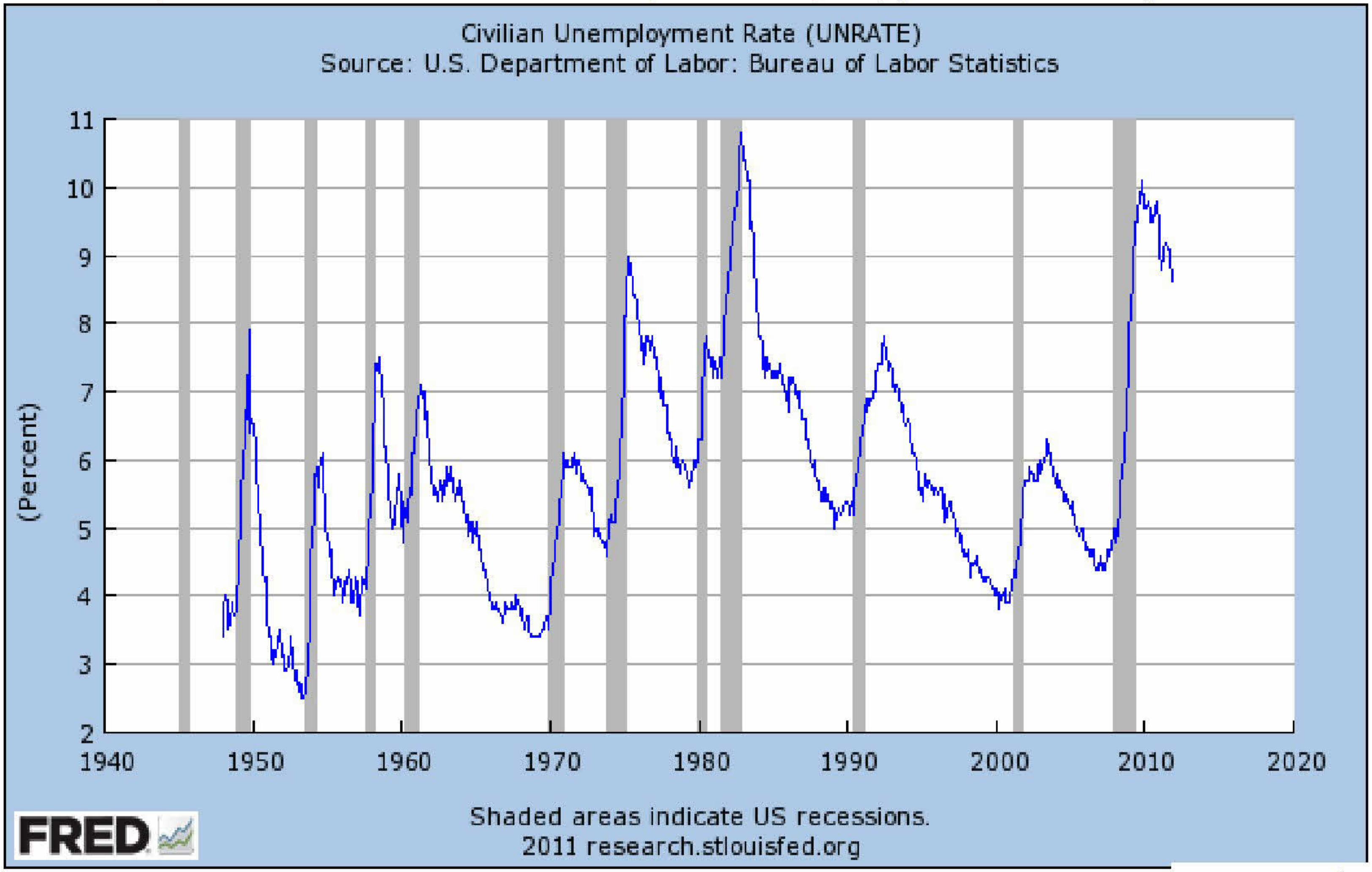
U.S. Unemployment Since 1947

Two points: How "real" are the current numbers now? And, how long will it take for jobs recovery to take hold now, viz., "escape velocity" of post-1982 compared to now?



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Current state of U.S. Economy

How long can this "recovery" last?

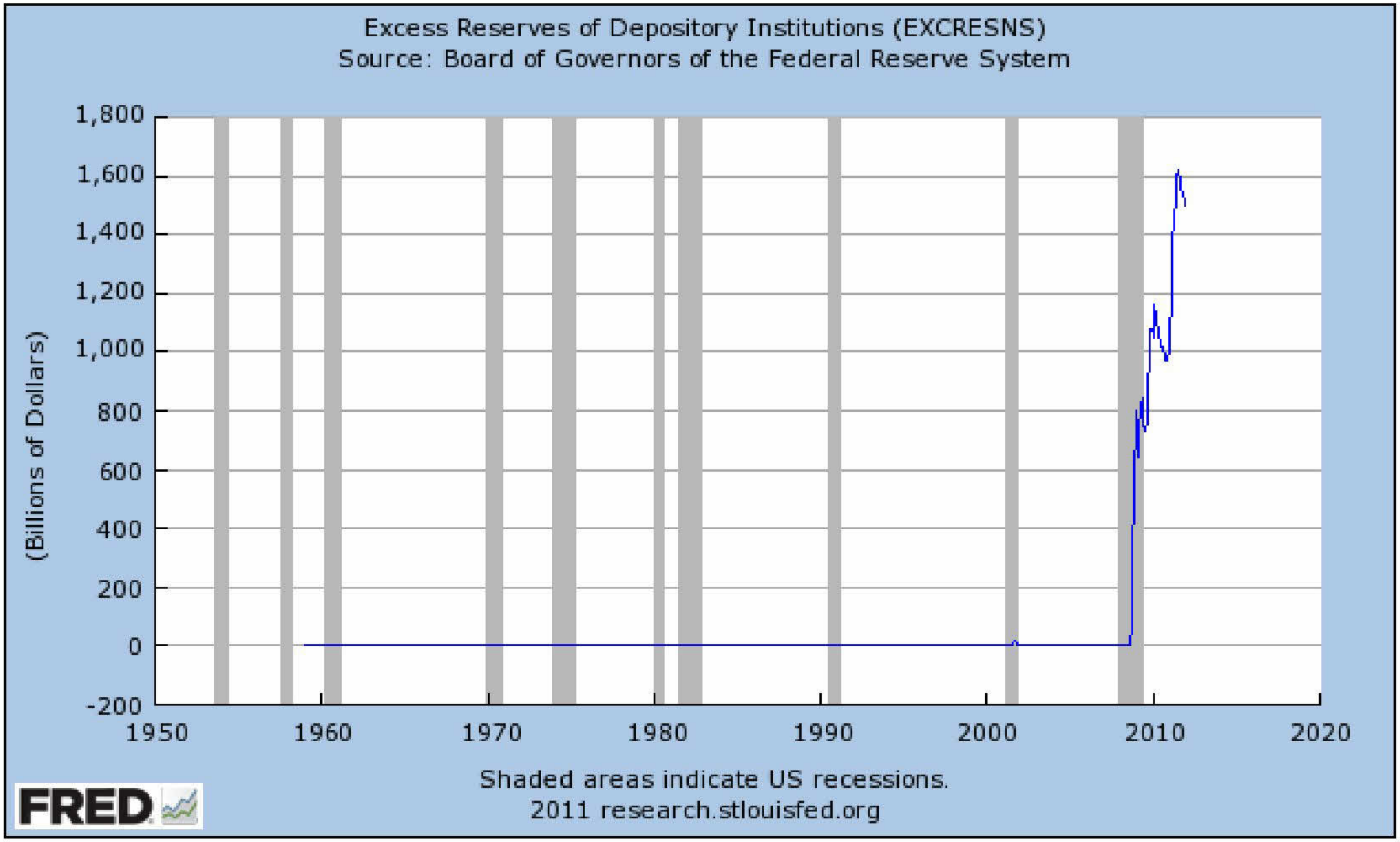
- 212000 jobs created in December; 2.9 million last two years
- 8.5% unemployment, down from 10.1%
- Corporate profits at all time high, 2nd year in a row – be about $1.56 trillion in 2011
- US equities up 90%+ since March 2009

BUT!

- 6.5 million fewer employed than four years ago – what's the real unemployment number? U-6 unemployment rate and shifting labor force participation make us wonder.
- No job growth in last twelve years is worst stretch in American history
- Real incomes have fallen nearly 10% since end of 2007
- Extraordinary level of fear for the future
    - Corporate cash in balance sheets at record elevated levels
    - Household demand for cash, liquid holdings very high; big bump in savings
    - Excess reserves at the Fed
- Inflation coming back → 3.5% in 2011, and look at gold, oil
- Status if state and muni fiscs are not any better than federal level, as Scott Walker can attest
- Entitlement disaster and national bankruptcy loom in our future

Excess Reserves at the Fed

It is questionable to what extent QE 1 and QE 2 helped the U.S. economy; draining these reserves "costlessly" is also an open question



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Economic Growth & Recessions ....(1)

We see echoes of the Laffer paradigm in classical economics

- **Adam Smith: "system of natural liberty" promotes prosperity: key idea is to promote productivity of labor – via these inter-related precepts**
  - **Private property → Incentives are optimized**
  - **The butcher, brewer, the baker:** "It is not from the benevolence of ***the butcher, the brewer*** or the ***baker***, that we expect our dinner, but from their regard to their own interest. We address ourselves not to their humanity, but to their self-regard"....
  - **Division of labor and specialization**
    - **"The division of labor is limited by the extent of the market"**
    - **Pin factory**
  - **Sound money (from David Hume)**
  - **Free trade**
    - **Enhances division of labor**
    - **Generally against tariffs**
    - **Comparative advantage promotes specialization**
  - **Limited government**
    - **Implies low taxes**

Key point: there is a natural order to free markets that promotes peaceful harmony and social cooperation. Given this, what causes recessions?

Economic Growth & Recessions ….(2)

We see echoes of the Laffer paradigm in classical economics

F.A. Hayek formalized and extended the teachings of Adam Smith. Growth and prosperity happen via:

- Smith's "system" generates knowledge via the supply-and-demand determination of market prices. Hayek emphasized *coordination* as the key economic problem

- Profit-and-loss system both conveys signals (knowledge) and directs resources

- Entrepreneurship (trial and error) is crucial for discovery process to ensue. Is always stifled in bureacratic or command economies

Ludwig von Mises built from Smith to develop the core story of a monetary theory of the trade cycle and recessions 100 years ago

- Do business cycles stem from "real" or "monetary" factors?
- Manipulation of money and credit (political) generates interest rate signals that are false

J-B Say: "Production is the source of demand." → Spending is not a *cause,* but an *effect,* of growth. All of these "giants" are precursors to Laffer formula: (1) Sound money, (2) low tax rates at the margin on capital and income; (3) control spending + (4) free trade + common-sense regulation = *laissez faire…. and prosperity is assured.*

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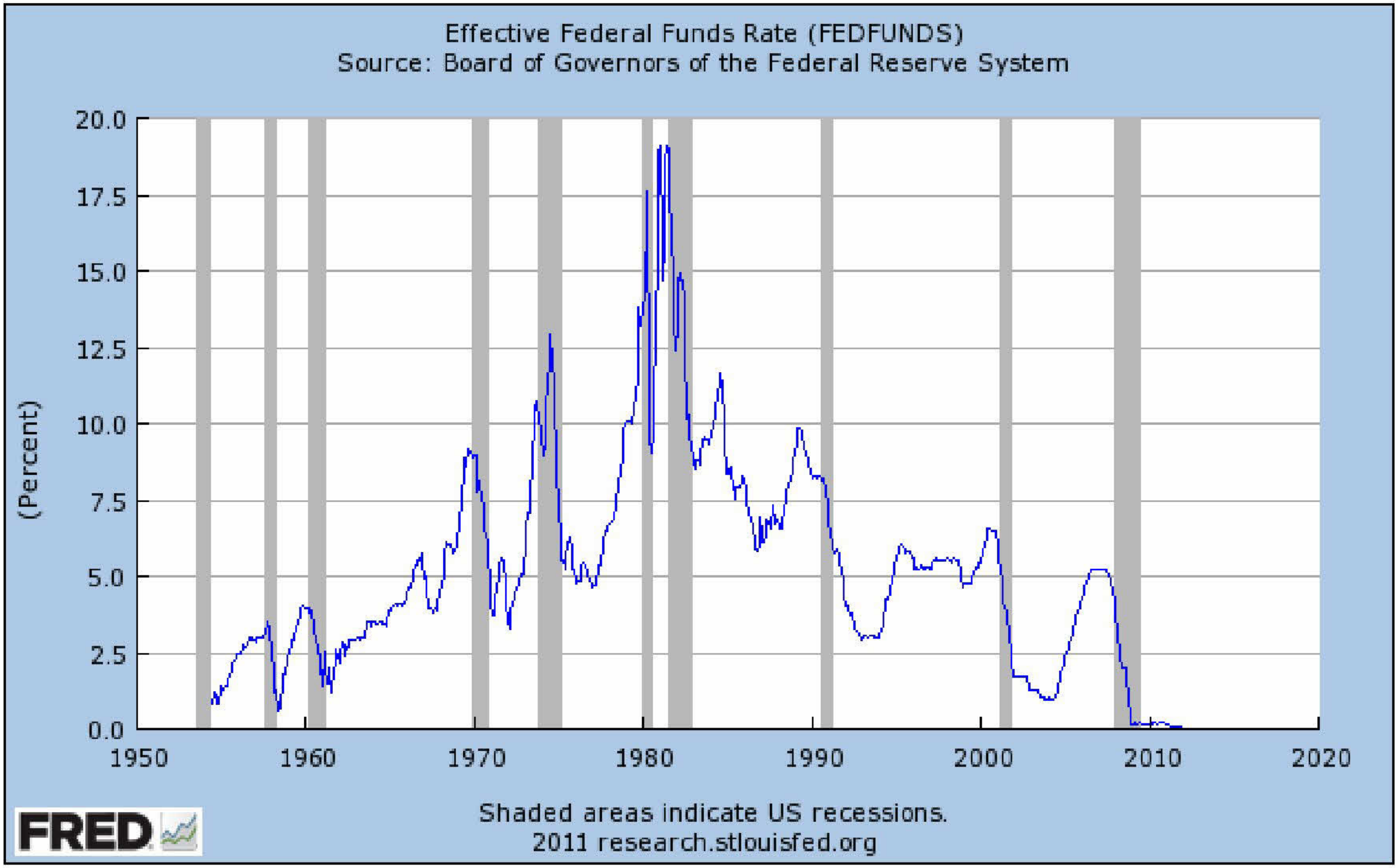
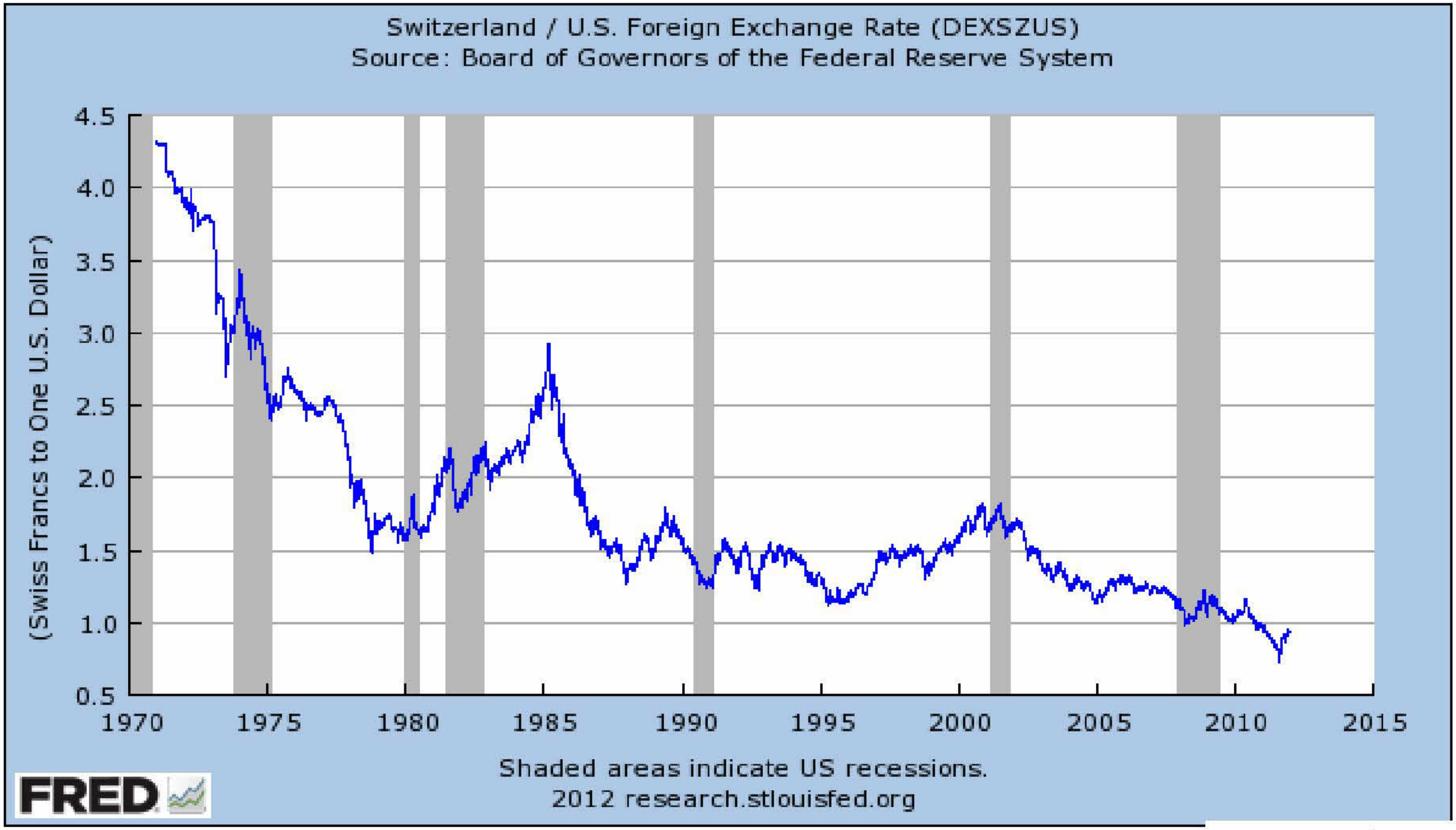
Monetary Sources of Recessions…(1)

Federal funds rate, 1954-Present. Spikes almost always mean recession is ahead.



Monetary Sources of Recessions…(2)

Swiss franc (SFr) versus the U.S. Dollar, 1970 to present. Note drop after Nixon abandons gold. Note dollar under Bush 43 versus Clinton, Reagan.



Postwar U.S. Economic Policy

A growing and prosperous economy is the result of good policy choices – viz., those that promote the institutional conditions which assure growth. The recent history of U.S. economic policy offers both good and bad examples

- 1970's: Nixon abandons gold, price controls, stagflation; but data not as bad as I thought!

Unemployment: 6.2%; Inflation 7.5%; GDP growth 3.3%; S&P 500 up 1.5% nominally; Investment down; 19 million jobs; incomes up 2.3%. ERISA law; Steiger cap gains in '78

- 1980's Recovery, Reagan boom sets off long run of prosperity

Unemployment: 7.2%; Inflation 4.7%; GDP growth 3.1%; S&P 500 tripled, up 13% nominally per annum; Investment way up; PE/VC revolution; AT&T bust-up spawns new communications era; 20 million jobs; incomes up 2.3%; nondefense spending DOWN in real terms; Reagan cut federal spending as % of GDP from 23% to 21%.

- 1990s: Prosperity continues as Clinton is saved from himself

Unemployment: 5.8%; Inflation 2.8%; GDP growth 3.2%; S&P 500 triples again, up more than 15% per annum; Investment strong; 21.5 million jobs; NAFTA; welfare reform. Clinton cut spending/GDP down to 18.2%. Nondefense spending grew only 0.5%.

- 2000s: Bush 43 diverts from Reagan path he promised; the prelude to disaster

Unemployment: 7.1% since 2000; Inflation 2.2%; GDP growth 1.7%; Personal income up 0.9% -- though down now 4 years straight (1st time since 30s); S&P 500 down 14.5% from 12 years ago; Investment down; ZERO jobs; Sarbanes Oxley, Medicare Part D; nondefense spending explodes 4.6% per annum.

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What caused the housing bubble and crisis?

A huge literature on this already. We think there were five major policy errors that fed on themselves:

***Policy Error #1:** The federal government was institutionally biased to promote home ownership in a mutually supportive arrangement between elected officials and the industry that spun out of control. Politicians seek votes, endearment, money, and "special favors." Fannie and Freddie were set up to provide all of these. In return, politicians agreed not to police Fannie and Freddie activities.*

***Policy Error #2:** The Federal Reserve's discretionary policy, as it had so many times in the past, ignited the boom and stoked it. Trouble could not have arisen if dollar policy were geared toward soundness and value stability. A gold dollar – and best yet, one with no central bank but freely competing banks who competed with each other based on strength of balance sheet – would never have enabled this episode.*

***Policy Error #3:** The federal government, because it was and is institutionally biased to promote home ownership, refused to make explicit the divorcement of Fannie and Freddie from the government. This encouraged unceasing demand for any debt instruments having Fannie and Freddie's imprimatur. (And course more broadly, Fannie and Freddie should have been broken up and liquidated long ago, but their existence and support have been too helpful to politicians to follow through on this.)*

The housing bubble and crisis…(2)

A huge literature on this already. We think there were five major policy errors that fed on themselves, and 4 and 5 are:

***Policy Error #4:** The government-mandated oligopoly for ratings agencies makes no sense in the modern world, and should long ago have been abandoned. Fierce competition would ensue in this business if permitted, forcing all of them to be better. And if forced to compete in an active and dynamic market, based on their reputation for accuracy, a much more stable back-drop to these securities would develop.*

***Policy Error #5:** FASB 157 (mark-to-market rules) had the practical effect of automatically throwing financial firm balance sheets into a march to insolvency in a market downdraft. Because once some assets are falling in value the firm may have to sell other assets to raise cash – but will soon find their values falling as well due to market pressure from too many sellers finding too few buyers.*

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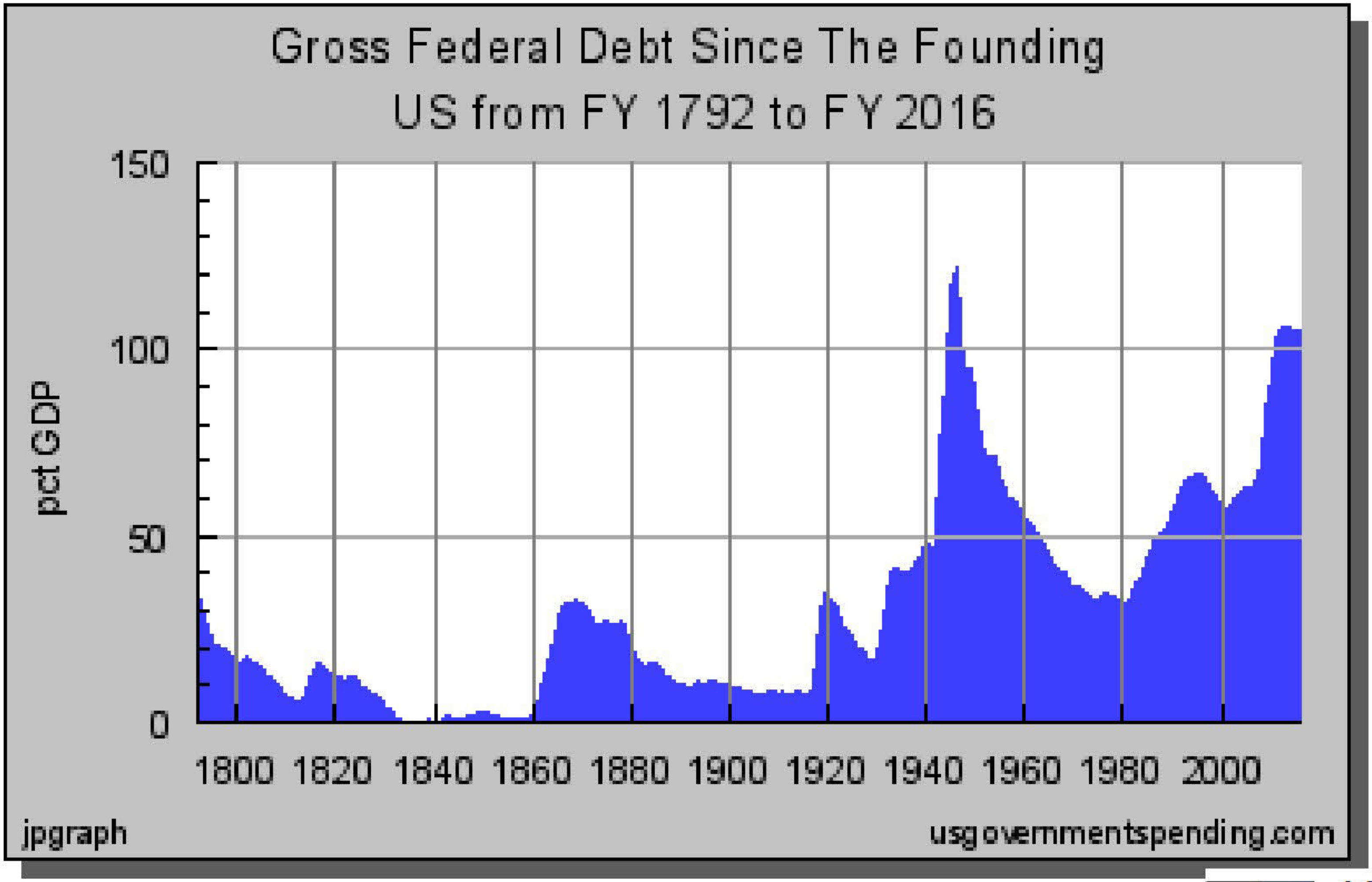
A parting warning on debt

Carmen Reinhart and Ken Rogoff have done extensive research on the effect of debt on economic growth. >90% is tipping point for permanent sclerotic growth



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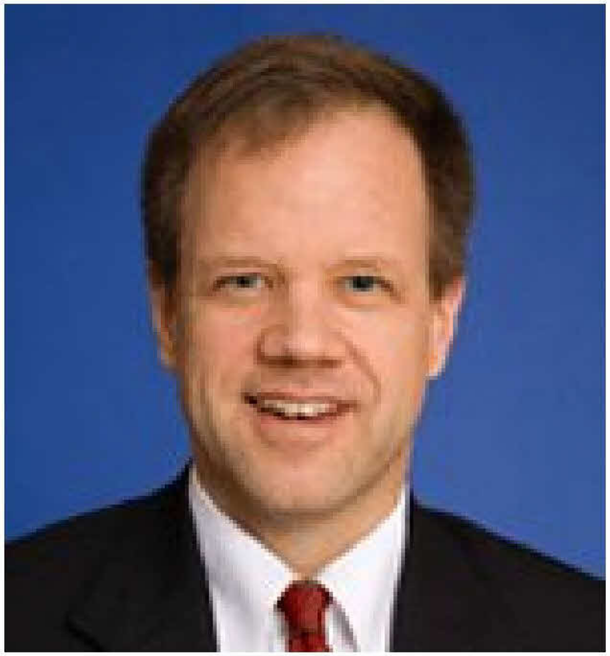

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    - Private equity
    - Entrepreneurship/founding of Goodyear
- Investment management
- Investment banking
- Insurance

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