
THE MUHLENKAMP MEMORANDUM

ECONOMICS - AND WHY THIS ELECTION IS IMPORTANT

In the past 35 years I have witnessed a fascinating experiment in economics. In the mid-1960s, when I was in college, the U.S. Gross Domestic Product (GDP) was growing at 4 - 5%, mortgage rates were 5 1/2%, and the unemployment rate was at 4 - 4 1/2%. Inflation wasn't even mentioned because it had been at less than 1 1/2% since the wars (WW II and Korea). All of this was considered "normal."

The economics books of the time discussed inflation in terms of "cost - push" and "demand - pull," with the underlying theme that inflation was caused by too much growth in the economy. The books also argued that government spending was at least as stimulative as private spending and was actually more effective at "jump-starting" an economy. As a capstone to all of this, I was taught that with the U.S. economy growing at 4% per year and the Soviet economy growing at 6% per year, GDP per capita in Russia would surpass GDP per capita in the U.S. in roughly the year 2000.

By 1968, the U.S. economy was enjoying its longest peacetime expansion ever. Consumer confidence was high and Wall Street was booming. Stocks like Litton Industries, LTV, National Student Marketing and Equity Funding were making investors millionaires almost overnight. A book, "The New Breed on Wall Street" featured the "hot" mutual fund managers of the day including Fred Mates, Fred Alger, and Fred Carr.

Economists were so confident of their ability to "fine tune" the economy that some university economic departments cancelled their courses on the business cycle. The point is - we've been here before, but we blew it.

Just eleven years later, in 1979, inflation was 10%; GDP growth was 2%; unemployment was 10%; and mortgage rates were 11% on their way to 15%. President Carter complained about a "malaise" in the American public.

What happened?

In the mid-1960s President Johnson wanted to fight the war in Vietnam and the "War on Poverty" at the same time, but he didn't want to raise taxes to pay for them. In order to finance the spending, the U.S. Treasury and the Federal Reserve expanded the money supply at a rapid rate (they printed excess money). As is usual, the early effects were beneficial; the negative effects took a little longer (sort of like using a credit card - the

payments are delayed). Gradually, as we kept printing more dollars, the value of those dollars fell. By 1973 the value of the dollar (relative to its 1965 value) had fallen 31%. Compared to other benchmarks, it had fallen 33% vs. the Deutsch Mark, 22% vs. the Yen, and 67% vs. Gold. All this time we were buying ever-larger quantities of oil from the OPEC Nations and were paying for it in ever-depreciating dollars. So, in 1973, OPEC raised the price of oil. This gave our politicians a scapegoat for inflation, but the politicians didn't change their policies. Why should they? Economic theory held that inflation was caused by supply and demand constraints, not by printing money.

By 1979, the dollar (relative to its 1965 value) had fallen 59%. It had fallen 57% vs. the Deutsch Mark, 44% vs. the Yen, and 88% vs. Gold. The dollar was so weak that President Carter deemed it necessary to appoint an "independent" Central Banker as Chairman of the Federal Reserve Bank. In order to rebuild confidence, President Carter had to choose someone whom our trading partners would trust to support the value of the dollar as

his first priority. He chose Paul Volcker. Also in 1979, I wrote an essay "Why the Market Went Down" to explain the impact of inflation on the stock and bond markets. (A copy of the essay is available on request or at our website www.muhenkamp.com under the Newsletter Archive section.) Based on this paper, we told our clients in 1980 that if Reagan and Volcker were successful in getting inflation under control, we'd have a good decade in the stock and bond markets.

Paul Volcker soon made it clear that he planned to grow the money supply at a 6% rate, and economic commentary hit the fan. The economic community argued as follows: "Inflation is 10% and is intractable. If you only grow the money supply at 6%, the economy will be forced to shrink at a 4% rate (6-10 = -4)." Volcker did it anyway. And by 1982 inflation fell to 4% with GDP growth of 2%. Volcker's action and the ensuing economic numbers proved that inflation is caused by printing too much money, not by too much growth. He also proved that GDP growth competes with inflation for money and that GDP growth can outmuscle inflation for the available money supply. Inflation was not "intractable." In fact, for a given growth in the money supply, higher growth in GDP actually causes lower inflation.

While we still have some economists and a lot of commentators believing that growth causes inflation, central banks have learned the lesson. As evidence of this, I'll cite the central banks of Europe. When their governments decided to adopt a single currency, the Euro, it was necessary to bring the inflation rates in several countries down to the level of Germany. They didn't even attempt supply/demand management. Each country set out to

"We've learned the lesson that Paul Volcker taught us. But the second lesson of the past 35 years, the lesson of Ronald Reagan, we haven't learned."

THE MUHLENKAMP MEMORANDUM

lower their inflation rate by controlling the growth in their money supply, and each was successful in lowering their inflation rate.

Today inflation is under control in each of the major countries and each of the major currencies of the world. Inflation is coming under control in a list of countries from Brazil to Chile to Greece. And the sensitivity to inflation of investors in the stock and bond markets gives me confidence that it will remain under control for the foreseeable future. We've learned the lesson that Paul Volcker taught us.

But the second lesson of the past 35 years, the lesson of Ronald Reagan, we haven't learned.

In 1960, real economic growth had slowed from the 4 - 5% rate of the 1950s. President Kennedy was advised by some economists to increase government spending to jump-start the economy. He was advised by a few others to cut taxes to jump-start the economy. He did both, choosing to go to the moon and to cut taxes. The economy resumed 4 - 5% annual growth.

As we said earlier, President Johnson simultaneously fought the Vietnam War and the "War on Poverty." He sought to pay for them by inflating the money supply. The first effect of this inflation was a decline in the value of the dollar, but another effect was on income tax rates.

In the U.S., we have progressive income tax rates. The tax rate progresses higher as your income progresses higher. So as your income increases your taxes increase faster. In the 1970s, these rates were not indexed for inflation. In fact, in the 1970s, if your income went up 10%, your federal income taxes went up 20%. This meant that if the workingman got a raise equal to inflation pre-tax, he was still losing ground after-tax. It also meant that professional people got bumped into ever-higher tax brackets, the highest being 70%.

At a 70% rate, individuals gain more by avoiding taxes than they do by producing more income. So many resorted to "tax shelters," which were designed to take advantage of provisions in the tax law, rather than produce useful or desired goods and services.

One day in 1979, I met with two doctor clients. They had a pension plan and a profit sharing plan, but they also had income deferral plans and were investing in a number of tax-shelter plans. I finally asked them how much time they were spending

on all this. They said, "About a day a week." So you had two intelligent, highly trained people spending 20% of their time and a lot of their investment capital on things that were non-productive. Actually you had many thousands of high-income people doing the very same thing.

With the average wage earner falling behind and the top wage earners discouraged from producing more, or from hiring others to produce more, is it any wonder that we had a "malaise" in the economy?

Ronald Reagan changed all that. He cut the top income tax rate to 28%. Tax shelters went away and the top earners went back to producing useful goods and services and hiring others to help them. But when Reagan announced his tax cuts, economic

commentary hit the fan. Economists maintained that his tax cuts would cause federal deficits, which would cause government borrowing and rising interest rates. Rising interest rates would "crowd out" private borrowing and shut down the economy.

They were right on the first part. Government deficits ballooned. But the economists were dead wrong about interest rates and the economy. Interest rates fell and the economy boomed. In June of 1991, at an M.I.T. reunion, I had a long

discussion/argument with an old classmate who graduated in economics and was, and is, the chief economist at a major consulting firm. He argued that the government deficits would drive interest rates higher. I argued that people's response to rates (by not buying ever larger houses with ever larger mortgages) would drive rates lower. (We published my argument in Muhlenkamp Memorandum #20.) T-bond rates at the time were 9%. By late 1993, (2 1/2 years later) they had fallen to 6%. In late 1993, we concluded that the bond rally was over (Muhlenkamp Memorandum #28).

The best explanation I've found for "The Reagan Lesson" came from a friend of mine, a professor of economics at Duquesne University. In 1980 he posed the question to me as follows: "Suppose you work a 5-day week, what you earn on Monday you pay 10% in taxes; Tuesday you pay 20% in taxes; Wednesday you pay 30% in taxes; Thursday you pay 40% in taxes; Friday you pay 50% in taxes. Would you come to work on Friday?"

In the past 20 years, I've asked this question of several thousand people. Until three years ago 2 - 5% of listeners would raise their hand. In the last three years, exactly one person raised his hand.

*"Suppose you work a 5-day week,
what you earn on...*

*Monday you pay 10% in taxes;
Tuesday you pay 20% in taxes;
Wednesday you pay 30% in taxes;
Thursday you pay 40% in taxes;
Friday you pay 50% in taxes.*

*Would you come to work on
Friday?"*

