



Russell 20-20 Association Annual Meeting, May 7, 2003

The Economics of Mass Destruction

Speech by Donald L. Luskin

I earn my living as an economist. I try to forecast how economic policies and ideas in the hands of government, business, media and academia move the world and move markets. Unfortunately most of what I see now in economics amounts to nothing but a conspiracy to keep you poor and stupid. That's the name of a book I'm writing, and a web site I run, at www.poorandstupid.com.

Economics was once a noble discipline of moral philosophy, but it has become so disconnected from the real world as to become utterly abstract and amoral. What was once a compass for bringing order to the challenge of collective action has become weaponized -- a tool for carrying out political warfare. The economics of mass destruction.

Sound absurd? The sciences of physics and biology were weaponized long ago, and you've seen the results. Why not economics?

Let's start with an example from close to home, of how economics has been weaponized for political warfare.

Paul Krugman is a Princeton University economics professor who writes a column twice a week on the op-ed page of the *New York Times*. He is an enormously influential public intellectual. Krugman made his reputation as an economist with revolutionary ideas about the dynamics of international trade, and many people think he's on the list for the Nobel Prize for that work. But Krugman's columns are unashamedly politically biased to the left, even by the standards of the *New York Times*. And he's not above using his prestige as a renowned economist to make his opinions seem like facts.

Krugman frequently writes about Bush's budget and his tax-cut proposals. Bush is turning America into a "banana republic." Bush is selling out "the little people." Bush is a stooge of "the plutocrats." Okay, that's just name-calling, no matter how prestigious the name-caller. But Krugman is smart. He's like one of those kids in grade school who could think of nasty nicknames for the other kids -- and somehow they always stuck.

An example. In his April 22 column, he wrote about Bush's claims that his tax-cuts will create 1.4 million new jobs.

"...let's pretend that the Bush administration really thinks that its \$726 billion tax-cut plan will create 1.4 million jobs. At what price would those jobs be created? ...The average American worker earns only about \$40,000 per year; why does the administration, even on its own estimates, need to offer \$500,000 in tax cuts for each job created?"

Now I have to tell you I don't by any means love everything about Bush or his administration. I'm not a Republican and I don't think of myself as a conservative. But I'm on the record as a big supporter of Bush's tax-cuts. I've talked about them with Bush personally, and I'm absolutely convinced that they're the right thing to do and that Bush deeply understands *why* they're the right thing. When I read that Krugman column, my heart stopped... \$726 billion in tax cuts, 1.4 million jobs, \$500,000 per job -- each job pays \$40,000. Bush is going to spend \$500,000 to get \$40,000? What is this crazy plan I've been supporting?

And then five seconds went by, and I saw it. \$726 billion is the cost of the tax cuts *over ten years*. \$40,000 is the average wage *for one year*. Krugman forgot to divide by ten! The Nobel short-list economist forgot to bloody divide by ten!

Or he deliberately didn't divide by ten.

But did the *New York Times*, American's "newspaper of record," issue a correction? No. So, as far as the public is concerned, it's a fact. So last week when Alan Greenspan was taking questions after his testimony before the House Financial Services Committee, what do you know -- Tennessee Democrat Harold Ford, who's expected to be John Kerry's running mate in 2004 -- asks Greenspan point blank: what about this terrible tax plan that will cost \$500,000 to produce a \$40,000 job?

We call this KARS -- Krugman Adaptive Repetition Syndrome.

Where do you think these people get their talking points? Do you think they really understand economics? Just before Congressman Ford's question, New York Democrat Carolyn Mahoney asked Greenspan about the personal consumption expenditure *deflector*! You can't make this stuff up...

In the latest issue of the *New Yorker* in the "Talk of the Town" column, it's there, too! \$500,000 to produce a \$40,000 job! And it's not even attributed to Krugman. It's simply become fact. Scientific fact.

It's like that scene in *Dr. Strangelove* where the Russian ambassador is telling the president in the war room about why the Russians built a nuclear "doomsday machine" -- because they thought the US was building one too. The president denies it, and the Russian ambassador snarls, "Our source was the *New York Times*!"

And who's going to refute it so that a congressman or a journalist is going to understand it? Weaponized economics is designed so that a congressman or a journalist can't understand it, any more than they could defuse an armed nuclear bomb. Economics has been transformed into a jargonized and mathematized scholasticism that is accessible only to its own elite.

For example, for one reason or another I did a web search last week to settle a bet about the break-up of the Beatles. And I happened to find this abstract of a paper by a couple of University of Michigan economists, called "Assortative Matching, Reputation, and the Beatles Breakup." Let me read to you from the abstract...

"Consider Becker's (1973) classic static matching model, with output a stochastic function of unobserved types..."

"We show assortative matching fails around the highest reputation agents for 'low-skill concealing' technologies. Our theory implies the dynamic result that high-skill matches (like the Beatles) eventually break up."

"... convexity due to learning undermines match supermodularity; and ... for a fixed policy in optimal learning, the second derivative of the value function explodes geometrically at extremes."

As you can imagine, I easily won the bet with my wife.

I don't want to be anti-intellectual about this. I'm sure this paper is a very high achievement, at least in the minds of the poor students who will be tested on it. But suppose public policy had to be decided based on it. Suppose laws, taxes, regulations had to be enacted based on it, enforced by the police power of the state that brought you shock and awe. Who would be qualified to vote on such things?

And yet that's precisely what's happening as congress considers Bush's tax bill. The abstruse models used to score the impact of Bush's proposals are utterly beyond the comprehension of anyone on Capitol Hill. Believe me, I talk to these people every day in the course of my work. They don't have a clue -- even their economists don't really understand how their own models work.

Do you think Republican Senator George Voinovich understands? He just understands that he doesn't like deficits. This is a man who has lived in the same house in Ohio with his wife for 40 years. They just installed their first dishwasher last year. He took out the first loan of his life two years ago to buy a Ford Taurus (he got a zero interest rate deal). How different would our world be if the science of economics could come down from Olympus and explain a few realities to this man -- this one key vote in the Senate -- who holds the fate of the US economy in his hands.

That's a big public decision -- but what about the medium-sized ones? Every time two companies decide to merge, a federal law requires that they undergo an antitrust review, and that review is conducted by economists who use theories and models and principles every bit as abstract as that paper about the Beatles.

Last year Nestle's made an offer to buy Dreyer's Ice Cream. And the economists at the Federal Trade Commission decided to block it because "the elimination of Dreyer's would likely lead to anticompetitive effects in the market for superpremium ice cream."

Did you know, before this, that there even was something called "the market for superpremium ice cream"? Well, there is now. Imagine some incredibly complex diagram covering the entire wall in the office of some Ph. D. economist serving a life sentence at the FTC in Washington with no possibility of parole. The diagram shows "the market for food." Now erase everything that isn't "the market for deserts," and then erase everything that isn't "the market for frozen deserts," and then erase everything that isn't "the market for ice cream." There's not much of that diagram left -- we're already down to something the size of a postage stamp. But now erase "the

market for cheap-o ice cream" and "the market for regular ice cream" and "the market for premium ice cream." That little thing you have left -- that thing that's about the size of Abraham Lincoln's nose on a penny -- is "the market for superpremium ice cream." And some economist's judgment that there wouldn't be enough competition in Abraham Lincoln's nose -- that's what blocked the merger and wiped out over a billion dollars of shareholder value with the stroke of an economist's pen.

And that was chump change compared to the damage done to the entire world economy by the Microsoft antitrust action, which was practically a Full Employment Act for economists for five years. By the way, it's no coincidence that Al Gore just joined the board of Apple. Bill Gates may be the world's smartest man when it comes to software, but he was a babe in the woods when it came to influence peddling. At least he used to be.

Now let's look at the application of the economics of mass destruction on the grandest scale possible. Consider Federal Reserve policy, the result of a vast apparatus of enormously complex databases, models, and theories employing an army of economists installed at the regional reserve banks and with the Board of Governors in Washington. What the Fed does affects the very fabric of our lives, here and abroad.

The Fed's basic function is simple. It's a print shop. It prints money for economic participants to use as a medium of exchange. That money is, in the end, non-interest bearing government debt -- but it can be created by fiat, without any lender agreeing to lend. So the amount of it in circulation has to be no more than the market needs for transactions, or the result is the all too familiar one: inflation. If there's too little in circulation, the result is deflation -- more rare, but just as damaging.

Milton Friedman had it right when he said "Inflation is always and everywhere a monetary phenomenon." In other words, it is the result of printing too much money compared to how much is needed. Yet that army of Fed economists is dedicated to thinking about an entirely different -- and entirely wrong -- explanation for inflation. They're focused on a notion economists call the Phillips Curve -- the idea that economic growth itself inherently causes inflation.

Sounds like one of Big Brother's slogans in *1984*, doesn't it. "Slavery is Freedom." "War is Peace." "Growth is inflation."

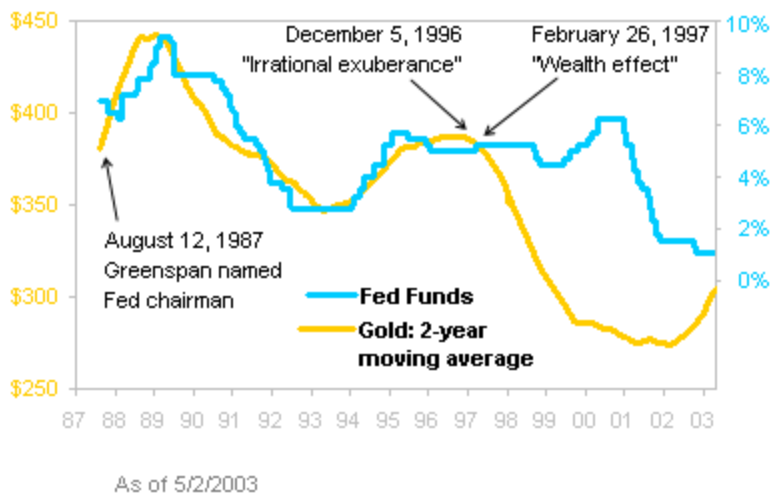
This slogan, this theory, this myth -- the Phillips Curve -- is so deeply embedded in economic thought as to be beyond serious question. Yes, Friedman himself won the Nobel Prize for questioning it -- for demolishing it, in fact. Alan Greenspan frequently says he doesn't believe in it. But the economics elite has managed to take even Friedman's work and contort it into a post-modern version of the Phillips Curve. They call it other things now, such as the "output gap model." But nevertheless, we find the FOMC at every one of its regular meetings declaring a so-called bias with respect to the Phillips Curve. Which is the worst risk, they declare in each published statement: the risk of economic weakness, or the risk of inflation? That's the trade-off we're given. Choose your poison.

But what possible evidence is there -- really -- for *that* being the choice? Who says *those* are mutually exclusive trade-offs? The 1970s was a decade of economic decline and massive unemployment, and yet inflation spun out of control. The 1980s and 1990s were decades of rapid

economic growth and rising employment, and yet inflation was virtually banished. That's thirty years of real-world evidence solidly refuting the Phillips Curve -- yet the economics establishment still clings to it. Can you think of any other branch of science that cares so little for real world evidence? And has so much power to affect the real world?

Strangely enough, Alan Greenspan knows all that. He's a maverick economist who was once an acolyte of the radical capitalist philosopher Ayn Rand. He wrote tracts for Rand railing against antitrust and defending the gold standard as a bulwark of human freedom. Appointing Alan Greenspan to the Fed in the August 1987 was the crowning achievement of the Reagan administration. When he arrived, he quietly threw out all that Phillips Curve claptrap and secretly put America back on a gold standard.

Now I have a chart here that shows what Greenspan did. One line on the chart is the fed funds rate over the time that Greenspan has been running the Fed. Superimposed on it is the two-year moving average of the price of gold. From the time Greenspan started as Fed chairman through December 1996, the two lines are virtually identical. For 9-1/2 years America was on a "virtual gold standard," or more precisely, a "price rule."



By all appearances, whenever Greenspan saw the gold price falling, he took this as a proxy, or a distant early warning system, that the level of all prices would fall. This indicated that there were too few dollars -- so Greenspan printed more (the Fed does that by lowering the Fed funds rate). When gold rose, he took it as a sign that all prices were rising, so there must be too much money in circulation. So he would sop some of it up by raising the fed funds rate.

As far as monetary policy was concerned, this was "the end of history." And it's probably no coincidence that just a couple years after Greenspan put all this in place, we saw the broader "end of history" that Karl Marx foretold when the Berlin Wall fell and the titanic struggle between communism and capitalism was concluded. But the winner wasn't exactly the one Marx predicted. That's no coincidence -- the Pax Americana was made possible by a currency as good as gold, just as the Pax Britannica had been a century earlier.

But then in late 1996 something very bad happened. On December 6, 1996, Alan Greenspan made his famous "irrational exuberance" speech. Then on February 26, 1997, in congressional

testimony, he offered for the first time his theory that rising stock prices amounted to "asset inflation" -- and that it was the proper job of the Fed to take that into account in policy decisions. At the FOMC's next meeting in March he hiked the Fed Funds rate, even though the gold price was falling. A decade of Greenspan's stealth gold standard had come to an end. And the "end of history" ended too.

The results were nearly instantaneous. When Greenspan failed to print the money required to arrest the drop in the gold price, soon all other commodity prices started to fall, too. Other metals. Materials. Food. Oil fell as low as \$10 a barrel for a while. It's something that has almost never been seen in history -- a monetary deflation. Just the opposite of those classic photos, in hyperinflations where you see wheelbarrows full of money. This time, it was money full of wheelbarrows. And none of the economic elite knew what was hitting them -- and either did Greenspan.

The wave of currency and debt crises that swept through Asia and other emerging markets over the next two years was the direct result of Greenspan's historic deflationary mistake. Any nation that pegged its currency to the dollar effectively imported Greenspan's monetary deflation. Fragile, export-driven debt-laden economies are rapidly destroyed by deflation, and that's precisely what happened. Finally in late 1998 Greenspan started printing money again -- for a while -- but by then most of the dollar-pegs had been abrogated anyway, and Russia had defaulted.

When the smoke cleared at the end of 1998 Greenspan wasn't blamed, because at that point America was entirely intact. The Fed had seen us through the Long Term Capital Management crisis -- a firm that made bad speculations on the outcome of all the chaos Greenspan had caused -- and that's all that anyone seemed to care about. Greenspan was put on the cover of *Time* magazine as head of the Save the World Committee, along with Robert Rubin and Larry Summers.

So after a little time had passed, Greenspan stopped the presses again -- and he kept them stopped until America *wasn't* intact any more, until he finally ended the greatest period of American economic expansion of the twentieth century. His monetary deflation hit everything, but hardest hit were the companies that were most asset-intensive and the most indebted -- it wiped out the real value of their assets, and increased the real value of their debt. It wasn't just the telecom industry, either. "Asset-intensive" and "indebted" also describes every pension fund, by definition.

Greenspan, of course, has been running the printing press frantically of late, trying to dig us out of the deflationary hole he created. I think he's done it, too -- and in the process, I believe he's gone back on his stealth gold standard. On December 19 of last year he gave a remarkable speech to the New York Economics Club, the very first sentence of which was an homage to the gold standard. He even talked about bursting the bubble -- and how no central bank should *ever* try to arrest asset inflation, and how he would *never* have done such a thing, because it would have damaged the economy. That's just Greenspeak for "I didn't do it -- and I'll never do it again." Gold closed at \$345 that day. That's where it is right now, too.

That speech gave us conviction that Greenspan's deflation was really over. Shortly after, we told clients that junk bonds -- the most deflation-sensitive domestic asset class -- would be the asset class of the year in 2003. So far they have been.

So shall we say all's well that ends well? Hardly. Greenspan's gold standard had an enabling role to play in the "end of history" in the late 1980s, and his abrogating that standard may have a role in the way history suddenly started up again on September 11, 2001. You see, Fed policy may be America's most important export product -- and our most influential instrument of foreign policy.

Yes, history has started again, thanks in part to Alan Greenspan. The new history is not the battle between communism and capitalism, but the battle between the globalized modern commercial establishment and the marginalized states that don't have a role in it. When Francis Fukuyama was writing his book *The End of History* a decade ago, another author, Benjamin Barber actually had it right -- *his* book was called *McWorld versus Jihad*. And *that's* our history now.

And the Pentagon knows it. One military strategist has described the **Pentagon's new world map** as consisting of two colors: the "core" -- the globalized modern world -- and the "gap" -- everyone else. In the Pentagon's new map, the gap equals the threat. The gap is the axis of evil. The gap has to be absorbed into the core. It is the case that no two countries that both have McDonalds franchises have ever gone to war with each other.

Getting countries out of the gap means a lot of shock and awe. And getting them into the core means lots of nation-building -- and *that* means overcoming the economics of mass destruction.

What keeps countries in the gap to begin with? Our economics of mass destruction that triggered the emerging markets crises of the late 1990s is one culprit. But don't get me started on the International Monetary Fund and its role in all this -- they're the Taliban, the "state sponsors," of the economics of mass destruction. Has there ever been a country "aided" by their usual prescription of high tax rates and devaluations that hasn't eventually been destroyed?

Iraq will be a test case of what could be a new world order, if we are wise enough. We've created a clean slate there -- and we now have the opportunity to create a vibrant, free economy there. We have the opportunity to put in a system of a low flat tax and minimal regulations. We have the opportunity to take Iraq's oil wealth out of the collective hands of the state -- it matters not whether it's a democratic state -- and return it literally to the people who own it. Nobel Prize winner Vernon Smith has excellent ideas that could be used for the orderly, distributed privatization of Iraq's oil wealth that would endow the Iraqi people with something even more precious than democracy -- capital.

If we get it right, one can even imagine an Iraq -- then a North Korea, then a Syria, then an Iran... who knows where it could lead... that would be the world's premiere growth investment opportunities, and a model for America itself to emulate.

But first, to paraphrase Shakespeare, let's kill all the economists.

Thank you.

About the Author

Mr. Luskin is chief investment officer of Trend Macrolytics LLC, and former vice chairman of Barclays Global Investors.