

The Ten Causes of the Reagan Boom: 1982-1997

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The Mystery of the U.S. Economy

One of the great mysteries of our time seems to be why the U.S. economy is so good. An article on the front page of the *Wall Street Journal* in early 1997 summed it up nicely: “Pinch me,” the reporter wrote. “A lot of good things are inexplicably happening. The economy tops the list. Economists remain mystified why.”

It’s no mystery that the current state of the U.S. economy is good. The numbers are undeniable. The U.S. economy grew almost 4 percent in the fourth quarter of 1996. Inflation is low, interest rates are low, and job creation continues at a slow, but steady, pace.

The mystery is why it is so good. What factors brought about this relatively blissful economic state? And will those factors continue to operate in the future?

In some quarters there is increasing concern about the long-term prospects for prosperity and special concern about the stock market. Alan Greenspan, the chairman of the Federal Reserve, has even warned about the “irrational exuberance” of today’s investors.

A lot of this uncertainty about the future stems from the fact that much of the good news we are now enjoying was unexpected. Few, if any, economists predicted the kind of real economic growth we have been enjoying. And just a few months ago most economists, and even those in the Office of Management and Budget, were forecasting low rates of economic growth--less than 2.5 percent--right on out to the end of this century.

The forecasting track record of economists does not inspire much confidence in their current or future predictions. I think the reason they have been consistently wrong is not because they are dumb (they are not) or not because they don’t work hard (they do) but rather because they do not pay enough attention to a number of noneconomic factors that have been driving the U.S. economy.



In February 1996, in a talk about the long-term prospects for the U.S. economy, I said that the prospects for prosperity were brighter than ever before in our history. I remember that prediction particularly well because, at least so far, it has turned out to be right.

The analysis I used at the time was not standard. I relied on a few factors--political and technological ones--that have a powerful effect on economic activity but are impossible to measure with precision. Since then I have added several more factors to the list.

Economists have a tendency to analyze only what is available in neat, historical tables. They seem to prefer a precise, irrelevant answer to a more relevant one fraught with uncertainty.

The econometric models, whose mathematical complexity once seemed to hold the promise of more-reliable forecasting, have been disappointing failures. There are just too many factors that determine future economic activity that are impossible to quantify.



John Maynard Keynes and Adam Smith

A little more than sixty years ago, in his influential book *The General Theory of Employment, Interest, and Money*, John Maynard Keynes addressed the question of the necessary conditions for economic prosperity. Although much of what passes for Keynesian economics today is of dubious worth, Keynes was a perceptive thinker, and a number of his earlier insights have been forgotten. For anyone familiar with the jargon in today's academic economic journals, perhaps the most striking thing about *The General Theory* is how much of it is written in clear, eloquent English, with virtually no use of mathematics.

Keynes argued that a large part of our economic activities “depend on *spontaneous optimism* rather than on a mathematical expectation, whether moral or hedonistic or economic.” He went on to write that “most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as a result of animal spirits--of a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities.” Further, he argued, “if the animal spirits are dimmed and the *spontaneous optimism* falters . . . enterprise will fade and die,” and he concluded with this: “economic prosperity is excessively dependent on a political and social atmosphere which is congenial to the average business man.” Another even more famous economist, Adam Smith, expressed much the same view some 180 years earlier, in 1755, when he wrote that “little else is required to carry a state to the highest degree of opulence from the lowest barbarism, but peace, easy taxes, and a tolerable administration of justice; all the rest being brought about by the natural course of things.”



The Best of Times, the Worst of Times

If you step back for a moment and take a look at our current degree of prosperity, it can be a bit puzzling. Don't we have a crushing federal debt and an annual deficit that stretches endlessly into the future? Aren't we losing thousands of jobs because of corporate downsizing and foreign competition? Isn't our educational system pretty dismal, with many young men and women having difficulty just reading and doing basic math? Isn't crime rampant; welfare and high rates of illegitimacy destroying families; millions of illegal aliens overrunning our borders; and drug use rising dangerously among teenagers?

But why then is the stock market, perhaps the best barometer of confidence in America's future, rising to new records day after day? I think the simple answer is that, despite the serious problems this country has, there are more powerful, positive factors that are overwhelming them.

Let's go back to the stock market again. If you look at the path of the stock market over the past hundred years or so, a remarkable story emerges--particularly since the end of World War II. The last thirty or so years are most interesting--and relevant--and maybe even instructive.

Let's go back to 1965. The Dow Jones average had risen to 1,000. Seventeen years later, after dropping sharply from time to time (down to about 600 in 1975), it had struggled back to 1,000. For seventeen years it was basically flat. In retrospect it is not surprising. Weighed down by the Vietnam War, a heavy tax burden, rampant inflation, and the possibility of a nuclear war between the Soviet Union and the United States, the stock market went--nowhere.

But something happened in 1982 and the stock market took off in its strongest, steadiest rise in history. In the past fifteen years it has risen from less than 1,000 to 7,000 in March 1997--a sevenfold increase. But why? What was so different between the past fifteen years and the previous seventeen?

I can't think of anyone who, back in 1982, predicted this explosion of wealth. And the last fifteen years have not been entirely friendly toward economic growth. Didn't President Bush push through a big tax increase in 1990? Didn't President Clinton get another big tax increase in 1993? Aren't we still running huge federal deficits? And yet the stock market keeps on climbing.

Remember what Keynes said about those "animal spirits," that spontaneous urge to action that depends on optimism, rather than mathematical expectations? Well, there are political and technological factors that can either be congenial--or not--to the average businessperson.



Ten Factors That Cause Economic Prosperity

For some time now I have been compiling a list of what I think are the fundamental factors that can have a powerful effect--either positive or negative--on our economic prosperity.

"I like to call it my Economic Prosperity Sea Level list."

Think of economic activity in the United States as a great ocean, where the deeper and calmer the water, the better it is for the investors who sail on it.

Most of the economic activity we watch and analyze is comparable to waves, which can run from mild to choppy to dangerous. When the airline unions strike or Alan Greenspan cautions or a severe drought damages agriculture, we can get economic wave action that can affect the market--but only temporarily. The water still remains deep.

This sea of prosperity can also be affected by economic tides. We call them *recessions* and *booms*. These ebbs and flows of economic activity are of much longer duration, and the water level does change. But most of us are used to this kind of cyclic economic activity and are confident that when the tide goes out it will--soon--come back in.

But then there are radical changes that happen infrequently, perhaps only once in our lifetime, that affect not the economic wave or tide action but the very level of the sea itself. Think of it as either a melting ice cap or global warming, but when the economic sea level rises or falls the consequences can be dramatic.

Today the economic sea of prosperity is rising slowly, inexorably. The factors causing this rise for the past fifteen years or so are not easily measurable. There are no neat historical tables that chart their course. But they all have a telling impact on economic prosperity. So far I have ten factors on the list.

The first three on the list, and perhaps the most important, are the requisites for prosperity that Adam Smith observed in 1755, namely, peace, justice, and easy taxes.



Number One

The most important fundamental factor driving the new prosperity of the past fifteen years is the disappearance of the threat of an all-out nuclear war between the Soviet Union and the United States.

When the historians of the future write of the 1980s they will probably note that President Reagan's greatest legacy was not his economic policies but his bold confrontation of the Soviet Union, which led to the end of the cold war and nuclear arms reduction.

The historians may not discern any clear relationship between the fading away of the nuclear threat and prosperity, but people will. The absence of the threat of nuclear war stretches out people's time horizons. If they believe they will live longer, their personal discount rates decline, which will be reflected in a downward trend in long-term interest rates.

Some intriguing, though little noticed, studies have been done on the relationship between personal savings rates and the fear of nuclear war. In the September 1993 issue of the *American Economic Review* two professors, Joel Slemrod of the University of Michigan and Bruce Russett of Yale University, argue that

“Someone who believes that a “world” or “nuclear” war is likely to occur within the next ten years or so would be expected to have a much higher discount rate for benefits in that time period than someone who believes war is unlikely.”

In their studies they show a remarkable correlation between the settings of the *Bulletin of the Atomic Scientists*' "Doomsday Clock"--that rough evaluation of the threat of nuclear war--and savings rates in the United States.

Simply put, they found that a decreased fear of nuclear war is likely to increase personal savings, and which is likely to decrease long-term interest rates. And low long-term interest rates are good for economic prosperity.



Number Two

The next item on the list is the mushrooming growth of capitalism throughout the world. In terms of justice, capitalism is the most just system for business ever devised. Private property and the rule of law create an environment that simply does not exist in any statist society.

During the 1980s the idea of communism died. The philosophy of communism and its cousin, socialism, became intellectually bankrupt. That stunning intellectual collapse led not only to the breaking up of the Soviet empire and the withering away of the threat of world nuclear war but also to an explosion of capitalism in nation after nation. Nothing is better for economic prosperity than the sure economic justice of capitalism.

Now, true, there are still a lot of live Communists and Socialists who are madder than hell about it and doing everything they can to stop the inevitability of the new capitalism sweeping the world. But the economic policies of countries flow from what people believe is right and what people believe will work. And as long as capitalism, not some form of statism, is the idea that people embrace, capitalism will continue to grow and strengthen. And as long as this trend toward free market justice continues, so will the prospects for economic prosperity.

Number Three

The third item on the list is easy taxes. The recent tax increases by Clinton and Bush have tended to make us forget just how high tax rates used to be. When President Reagan took office in 1981 the top marginal personal income tax rate was 70 percent.

We have retreated a bit from the low tax rates of the mid-1980s, but compared to where we were before we began the fifteen-year prosperity ride we are now on--tax rates are still relatively low.



Number Four

Fourth on the list is the computer/communication revolution. Powered by spectacular technological progress in communications and computers, the entire world of business and finance has been compressed and speeded up. During the past fifteen years we have seen astounding advances in the processing and transmission of information.

It is as if someone had a big can of WD-40 (that all-purpose lubricant) and was spraying it on the machinery of free enterprise, making all of it hum and whirl with increasing efficacy. The personal computer, cellular phones and pagers, faxes and copying machines, and now the Internet--all of them are great for prosperity.

Number Five

Next on the list is the control of government spending. During the past fifteen years this has been the most intractable and disappointing part of our economic policy, but even this now seems to be coming under better control. Primarily due to defense cuts that flowed from winning the cold war, the federal deficit has been reduced this year to 1.4 percent of our gross domestic product, the lowest level in more than twenty years. Today both political parties are committed to a balanced budget--at least by the year 2002--and the current debate is over whether or not we should include a balanced budget requirement in our Constitution.

Number Six

Then there is the government regulation of business. Overall, the onset of new government regulations slowed considerably over the past fifteen years. There was even a significant amount of deregulation. Remember when the controls on gasoline and oil were lifted in 1981--and the gas lines miraculously disappeared.

Except for that brief flirtation with turning our health care system over to federal control in 1993, the days of big new government regulations appear to be over. Reasonable, minimal government regulation is a key element in any recipe for economic prosperity.



Number Seven

Monetary policy is next on the list. During the past fifteen years our country has been blessed with two of the best leaders the Federal Reserve System has seen: Paul Volcker and Alan Greenspan. Overall, monetary policy has been stable and predictable and inflation has been low, which has been a powerful factor in ensuring steady economic growth. That kind of sound, dependable monetary policy is essential for long-term economic prosperity.

Number Eight

On my list of things that lift the “animal spirits” is something that, if done properly, is barely noticed. That is policy consistency.

The past fifteen years or so have not seen a totally consistent economic policy but, compared to what we saw in earlier decades, it has--overall--been very, very good. The control of government spending has improved, tax rates have stayed close to the low levels set in the early 1980s, regulatory pressure has eased, and monetary policy has been superb and steady.

It can be argued that even a bad economic policy, if consistent, will eventually allow fair results as people get to know it and figure out how to work around it. But an economic policy that is both good and consistent is good for prosperity.

Number Nine

The next item on my list is our stock of capital. Any nation’s level of prosperity is dependent on the base from which it begins. During the past fifteen years an enormous amount of wealth has been added to America’s economic base--so much that it is perhaps impossible to comprehend.

Our economic base is worth tens of trillions of dollars and is still growing. Our stock of factories and homes, of schools and roads and every other kind of tangible asset you can think of has increased tremendously. Our intellectual capital has increased perhaps even more, especially in such critical areas as computer technology and software.

The base of our industrial machine dwarfs that of any other nation on earth. With that kind of capital it’s hard not to be prosperous



Number Ten

The last point is superiority. In this new global economy the United States economy may not be perfect, but, taking all relevant factors into consideration, it is simply the best.

If anyone doubts the superiority of the U.S. economy try this exercise. If you wanted to invest or start a business in any other society in the world where would you go? Canada? Russia?? Japan? Cuba? Germany? China?

Being the best means we draw investment from all over the world from those concerned with an optimum blend of opportunity and safety. And, in a free enterprise world, being the best is great for economic prosperity.

So if you look back at the course of the past fifteen years and examine the major changes in politics and technology that have occurred, some of the mystery of why the stock market has gone so high disappears. The investors may not have had an econometric model to guide them, but, on balance, they seem to have known what they were doing.

An even more interesting question is to what degree this economic prosperity will continue in the future. There is no crystal ball; it is a matter of personal judgment that only an individual can make.

But if we run down the list of the ten factors that raised the sea level of economic activity during the past fifteen years or so, we probably can make an informed judgment as to whether or not those factors will continue to be in play in the months and years ahead. And from that maybe we can deduce our own personal forecasts.



Here's the list again:

1. The vanished threat of nuclear war. *The vanished threat of a world nuclear war should hold for a long time to come. There will be an increasing threat of an accidental attack or one from a small, rogue state, but the construction of a small missile defense system could greatly reduce even that threat.*
2. The spread of capitalism. *Shows no signs of abating. No new statist theories on the intellectual horizons.*
3. Easy taxes. *At least for the next four years the chances of any major tax increase in the United States are close to zero, especially if the Republicans continue to control Congress. Both parties are now committed to some form of a tax decrease. We may even get a major reduction in the capital gains tax rate.*
4. The computer revolution. *Shows no sign of abating. If anything, it may be speeding up.*
5. Control of government spending. *This is the most difficult to predict, but at least for the next few months things look pretty good. In fact, the prospects for correcting the consumer price index are increasing, which could mean savings of hundreds of billions of dollars.*
6. Deregulation. *There is not even a whiff of any major new government regulatory programs. Pressure still strong to reform and reduce regulation.*
7. Stable monetary policy. *Alan Greenspan is good for another four years. After that it depends a good deal on who succeeds him.*
8. Steady economic policy. *There seems to be a developing unanimity on the key policies necessary for economic growth. The five pillars are (a) spending control, (b) low taxes, (c) reasonable regulation, (d) sound monetary policy, and (e) consistency.*
9. The U.S. capital base. *Every year it just gets bigger and more powerful. No sign of any decline, either in real or intellectual terms.*
10. The superiority of the U.S. economy. *The U.S. economy is now more than twice the size of its closest competitors. Even with prodigious advances by other nations it would be decades before even a Japan or a Germany could begin to even draw close.*

The more you examine the powerful political and technological factors affecting the U.S. economy, the less mystery there is about its robust condition. The U.S. economy is good for good reasons.



The Future

Where the U.S. economy will be a year from now, or five years from now, depends heavily on powerful political and technological forces that affect, as Keynes would say, the “urge to action” of men and women in the financial and economic community. But right now, toward the end of 1997, the prospects are uncommonly bright.

The U.S. economy is the most powerful economic engine yet devised. Its power just keeps on growing and shows no sign of abating in the foreseeable future. If those ten factors that have raised the level of the economic sea in the past fifteen years stay positive, we should not be surprised to see the Dow Jones average hit 10,000 or higher before we see the end of the twentieth century.

As President Reagan once said, “You ain’t seen nothing yet.”

Luncheon talk by Martin Anderson to the Franklin Templeton Group on March 6, 1997, in Newport Beach, California. Moderator: Paul Kangas of the Nightly Business Report for the Public Broadcasting System.

