WILLIS INVESTMENT COUNSEL

Principled Investing

JUST A THEORY[1]

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IS THE ECONOMIC TORCH BEING PASSED TO THE NEXT GENERATION?

In an April 29, 2021, essay in the *Wall Street Journal* by Jon Hilsenrath titled *Behind Biden's Big Spending Plans, the Waning Sway of Economic Caution*, he posited "a torch is passing in economic thought and economic policy." To set the stage for this inaugural issue of *Just a Theory*, Hilsenrath's essay opened as follows:

> When Lawrence Summers criticized the Biden's administration's new economic policies in recent weeks as being the least responsible in 40 years, you might have expected the warning to jolt Democrats. Mr. Summers, after all, was formerly the U.S. Treasury Secretary under President Bill Clinton, the president of Harvard University, and the economic adviser personally tapped by Barack Obama to help him navigate the financial crisis of 2008-2009. Instead, Mr. Summers was largely dismissed by his fellow Democrats. Progressives shouted him down on Twitter after he warned that the new administration's $1.9 trillion economic rescue program <u>could overstimulate the economy</u> and spark inflation. …. Behind the drama, the party's resistance to Mr. Summers's call for moderation is a sign that <u>a torch is passing in economic thought and economic policy</u> (emphasis is mine). Exiting the stage after a long run in power is a group of accomplished centrist economists who came of age during an inflation spiral in the 1970s and governed from the 1990s to the 2010s, with a mixed record of success and failure.

[1] *Just a Theory* reflects my belief that with economic and investment decision-making we often know <u>less</u> than we think we do. We often fail to accept the <u>limitations</u> of our analysis, we are over-confident, and sometimes fall into epistemic arrogance. This memo uses the word and concept of *theory* in the non-scientific sense. That is, it uses *theory* more as a means to frame one's thinking than the more scientific testable-hypothesis-theory framework.

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HISTORICAL CONTEXT

Before examining Hilsenrath's statement that "a torch is passing in economic thought and economic policy," some historical context will be helpful. For the most part, inflation and high interest rates (or the threat thereof) were major issues from around 1970 – 2000 (interest rates did not hold below 6.00% until June 2000). The below graph from Bloomberg reminds us of that era (red line is interest rate; white line is inflation):

During this period, many economists believed government debt and deficit levels were connected to high interest rates and inflation. For example, many thought if fiscal policy was not conservatively managed (i.e., an overly-stimulative level of government debt and deficit), then higher interest rates and inflation would likely result. Similarly, if the Federal Reserve "over-stimulated" the economy with low interest rates, then that too would likely cause inflation.

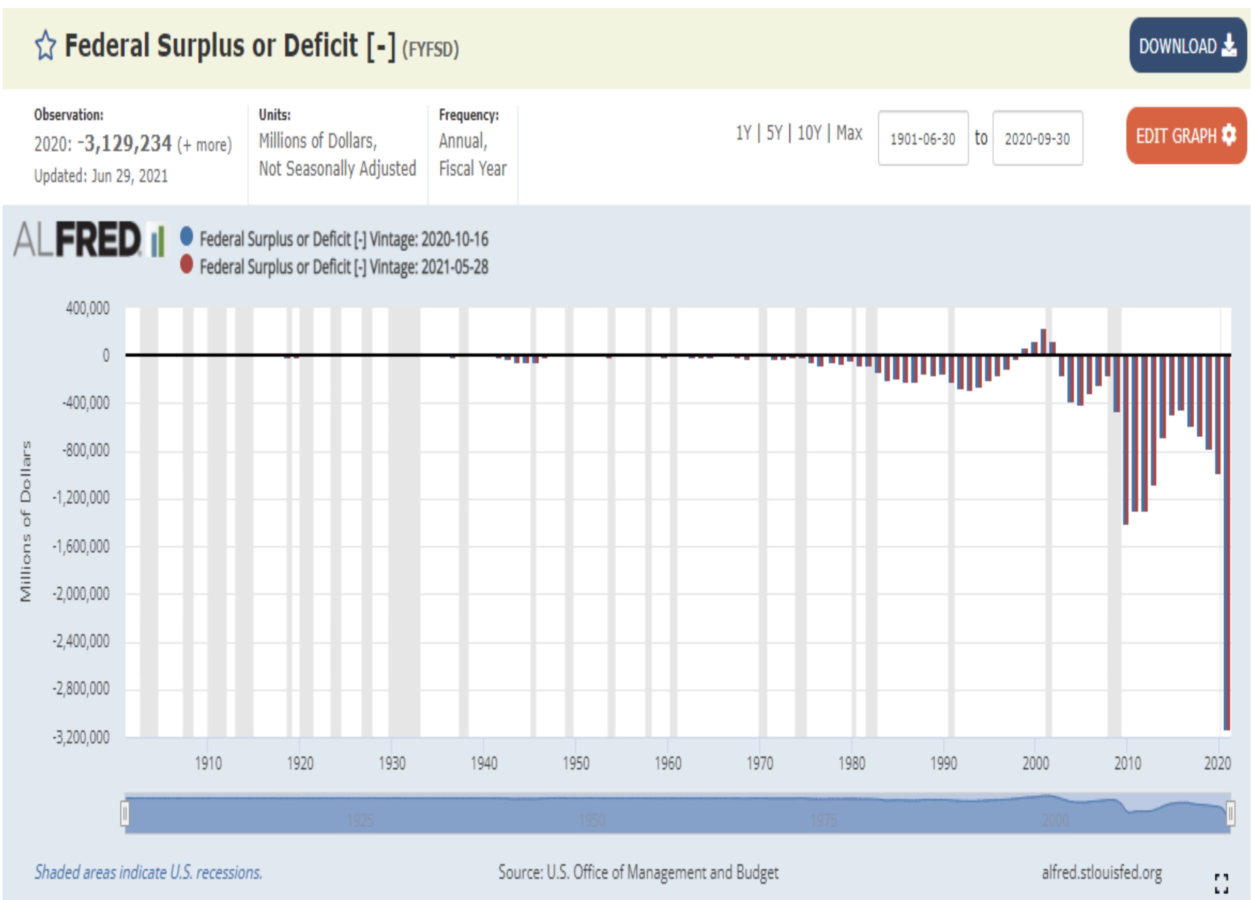
The same was essentially true with Congress. Because it was relatable to one's family or business finances, and just plain common sense, a sufficient number of members of Congress generally embraced some notion of fiscal discipline. Although the extent of government policy discipline varied along the political spectrum, usually there were enough leaders in Congress who favored some level of fiscal discipline and who respected the risk of inflation.

The White House and Congress, along with their economic advisors, all had something in common: the actual history they had lived through. This was a very powerful influence on their thinking.

It's basic human nature that one's actual experience or history naturally causes people to believe what they see and experience. For decades, economists and policy makers experienced troublesome inflation and high interest rates, conditioning their view that these were serious issues. History has changed.

20 YEARS OF HISTORY CAN APPEAR CAUSAL, BUT IS IT?

Before looking at interest rates and inflation, along with federal debt and monetary policy, let's look at the historical trend of the federal deficit. The following graph shows the historical trend of the federal deficit. Since the mid-1980s, and especially since 2000, deficits have become the norm:



The bars below the solid line represent U.S. government budget deficits. Only time will tell if it matters, and to what extent, that federal deficits become "standard operating procedure" as seems to be the case.

Hilsenrath's statement that "a torch is passing in economic thought and economic policy" grabbed my attention. He rightly characterizes the growing disregard for potential rising inflation and interest rates as "grounded in what has not happened over the last 20 years." Read that again – what has not happened. For most of the last 20 years, interest rates and inflation have steadily declined – not risen – in the face of an ever-increasing government debt, deficit, and money supply (M2). That defies conventional thinking. Consider the following Bloomberg graph of interest rates (the U.S. Treasury 10-year yield), inflation, U.S. government debt, and M2 (money supply-one measure of monetary policy):[2]

When one studies the above graph, the data *appears* to be clear – there appears to be a clear cause-and-effect pattern. The pattern, the trend, is easy to extrapolate. It is human nature to look at the above graph and conclude "overly-stimulative" fiscal and monetary policies (see the rising blue and green lines in above graph) of the past 20 years have not, and will not, cause inflation or interest rates to rise (see the flattish white and red lines in the above graph). At least, the above graph becomes a persuasive argument that continued stimulation will not necessarily cause inflation or interest rate problems.

[2] Not a straight-line decline, but overall a steady downward trend in interest rates and inflation. Inflation did not begin steadily declining until September 2005. To some, this trend indicates loose, accommodative, or expansionary fiscal and monetary policy have not caused rising interest rates or inflation; and some go a step further and extrapolate this trend as predictive of the years ahead.

Humans (most of us) too easily and readily overlook the fact the last 20 years is but one limited time-period; or that the last 20 years may or may not be representative of what the next 20 years might hold; but extrapolation is a very powerful, insidious, and persistent force.

COGNITIVE PSYCHOLOGY IS PART OF THE PASSING OF THE TORCH

If "a torch is passing in economic thought and economic policy," basic cognitive psychology is probably at work. The reduced concern of economists and policy wonks about the risk of sharply rising government debt and over-stimulation (fiscal and monetary policy) is likely grounded in human nature - in cognitive psychology. There are many well-documented forces that exist in all of our thinking and decision-making neural circuitry that have a powerful, and often insidious, influence on our thinking and decision-making.

Representativeness, *case-rate-versus-base rate*, and *extrapolation* are probably playing a significant role in the passing of the economic torch described in Hilsenrath's essay. These are all well-documented heuristics that often short-circuit rational decision-making. For example, the essay prominently notes "the new approach … is grounded in what hasn't happened over the past 20 years." A narrowly selected time period – the last 20 years – limits the frame of reference and sample size in a potentially misleading manner. The last 20 years may not be sufficiently representative of economic history. Our neural circuitry often does not care about sample size; plausible is good enough.[3]

Our decision-making apparatus has a strong tendency to extrapolate whatever trend *appears* to be prominent and controlling. And to make that tendency even more dangerous, we readily accept plausibility – plausible is often sufficient for us to reach conclusions. So, when one considers these human nature decision-making forces, along with the fact that more and more prominent economists and policy makers did not live through or directly experience the issues with high inflation and interest rates, it's understandable there seems to be a waning concern about the possible negative consequences of rising inflation and interest rates. Because 20 years may not be sufficient or dispositive history, George Santayana's admonition still applies.

Think about the economists that likely advised the White House, Congress, and policy makers for much of the last 30-40 years. They probably believed government debt and deficit levels mattered and were to be prudently managed. They also believed inflation was a very serious economic force that should not be taken lightly. So, when those leading economists found themselves as advisors to a president and in senior positions in an administration, their counsel naturally followed their beliefs – debt, deficits, and inflation mattered.

[3] See Daniel Kahneman; *Thinking Fast and Slow;* and James Montier*; Behavioural Finance.*

DOES THE BIDEN ADMINISTRATION SMELL BLOOD ON THE TRAIL?

For most of the last thirty years, interest rates and inflation have been falling (not in a straight line, but generally falling). Especially since around 2000-2002, "high" inflation and "high" interest rates have not been a significant economic issue.

Again, it is basic human nature and part of the hard-wiring and neural network of our brain's decision-making to extrapolate. That human nature tendency makes it almost natural to believe this current trend of rising federal debt and deficits not triggering rising inflation and interest rates will likely continue. That powerful decision-making force, together with the fact the old economic guard may no longer be in control, may represent a seismic shift in fiscal and economic thinking and policy making.

If those influential economists and members of Congress, who believed in monetary and fiscal policy discipline are no longer in power, then maybe the smell of blood is on the trail. Maybe President Biden and his team sense an opportunity to change the economic policy rules of the game. Maybe they can point to the interest rate and inflation graphs for the last 20 years and say the old rules do not apply anymore.

They can argue potentially beneficial policies (including social policies) should not be constrained by fears of inflation and high interest rates when neither has been problematic for 20 years. As is always the case, the White House and Congress can easily find economists, academicians, and research – including graphs – to support the new rules of the game they want instituted. And now they probably have the votes to do so.

Perhaps history really has changed. Perhaps the last 20 years is more representative of the next 20 years. Perhaps, but unknowable. The lessons of economic history, especially its inherent cyclicality, are no different than all history lessons. Only time will tell if history has changed; if debt and deficits don't matter; and if the economic torch is indeed passing.

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