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American Capitalism, Debt and Tailwind

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"God bless the U.S.A., so large,
So friendly, and so rich." W.H. Auden, *On the Circuit*

The poet W.H. Auden, born in England, recorded these and other partially tongue-in-cheek, but partially heartfelt, observations about America in 1965, when the country's gross national product was $742 billion, or $3,800 per person. By 2018 America's gross national product was $20.5 trillion, or $63,000 per person. Adjusting for inflation, America in 2018 was about two and a half times richer than the land Auden had observed in 1965. We can presume that Auden, had he lived until 2018, would have continued to find the U.S.A. "so rich" and "so large" (and before we scoff at the notion that Auden would also still find us "so friendly," we should put away our nostalgia for 1965 and remember that that year saw the rapid escalation of US military forces in Vietnam, violent attacks one "bloody Sunday" against civil rights marchers near a bridge in Selma, Alabama, and that two years earlier JFK was assassinated).

In any event, Auden was not the first observer of America to be startled by its wealth, although the humor and poignancy of his poem is likely unique. As Alan Greenspan, the chair of the Federal Reserve from 1987 to 2006, reminds us in his recent book, *Capitalism in America*, Alexis de Tocqueville, another great foreign-born observer of America, found during his travels in the early 1830s that "the entire society is a factory" and that he knew "of no country, indeed, where wealth has taken a stronger hold on the affections of men."

Greenspan and his co-author Adrian Wooldridge seek in their book to not only provide a history of capitalism in America, but also a history of the ideas used to justify or oppose American capitalism as it developed, while also trying to explain how a "collection of thirteen colonies in the middle of nowhere transformed itself into the mightiest economy the world has seen."

Greenspan and Wooldridge argue that three ideas underlay the wealth generating success of American capitalism to date. First, the Constitution turned the country into "something unique in history" and "did far more than anything else to guarantee America's future prosperity" by securing property rights, establishing the world's largest market by banning internal tariffs and by extending legal protections to intellectual property and the world of ideas. Second, in the mid-1800s the law authorized the formation and streamlined the creation of "publicly owned joint-stock corporations", thereby enabling the modern corporate form and, with it, the rise of the giant corporate entities that have bestrode the world like a colossus for at least the past 125 years (the President of Columbia University from 1902-1945 labeled this development "the greatest single discovery of modern times"). Finally, the country has accepted the pain and disruption that is an inescapable part of the process of creative destruction, a process that over time has dramatically improved living standards and the quality of life for virtually every American.

Capitalism in America also reminds us that economic trends and circumstances which seem to be inevitable and as natural as the air we breathe would be foreign and strange to Americans of other eras. In particular, during the 35 year period from the end of the Civil War in 1865 to 1900, deflation ruled the day. Prices declined during this period an average of 1.9% a year, meaning that over a 35 year period prices fell by more than 60%. A 1900 dollar, in other words, had over 200% the purchasing power of an 1865 dollar. By contrast, a 2018 dollar had about 40% of the purchasing power of a 1983 dollar, i.e., in the 35 year period between 1983 and 2018, inflation caused the dollar to lose about 60% of its value.

Accordingly, those who lived through the extended period of deflation from 1865-1900 would have understood that if they borrowed money, the dollars they would use to pay back the loan and interest in the future would be much more valuable than the dollars they received when they took the loan. Employers understood that with prices constantly falling, the only way to stay competitive and to pay debts was to consistently cut wages. And farmers to maintain their income could do so only by producing more food. Politicians also understood that the deflation effectively transferred wealth from borrowers in the South and West to lenders in the East. In short, to the hundreds of millions of Americans who have come of age after World War II, a period of constant inflation, life in a deflationary environment for a 35 year period is simply unimaginable.[*]

Ironically, while Greenspan not surprisingly gives credit to his predecessor Chairman of the Federal Reserve, Paul Volcker, for breaking the unprecedented inflation which plagued the nation in the late 1970s, he otherwise expends very little ink discussing the role of the Federal Reserve in ensuring consistent inflation during the post-WWII experience, and never deflation.

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[*] This 35 year deflationary period caused political turmoil, most famously in William Jennings Bryan's "cross of gold" speech at the Democratic Convention in 1896. Although Bryan "lost the battle" in 1896, and in 1900 and 1908 when he was again a Presidential candidate, he "won the war" against the gold standard first by the creation of the Federal Reserve System in 1913 which allowed for the substitution of "the expendable sovereign credit of the United States for gold," and decisively in 1971 when President Nixon ended the last remaining promise of the US to back its currency with gold, by closing the so-called "gold window."

Instead, Greenspan rails against entitlements and regulations, blaming them for sapping the entrepreneurial spirit of the country and threatening its long-term fiscal health with out-of-control spending. According to Greenspan and his co-author, the most important reason GDP growth in the 21st century has not kept pace with historical trends "is the growth of productivity-suppressing entitlements – the collection of social benefits (primarily Social Security, Medicare, and Medicaid) that Americans enjoy simply by right of being Americans." The "United States is now encrusted with entitlements" – 55% of "all U.S. households receive cash or in-kind assistance from at least one major federal entitlement program."

Greenspan and Woolridge are certainly not alone in their concern that the US has an entitlement problem. For example, on March 20, 2019, Martin Feldstein, a professor at Harvard and former Chairman of the Council of Economic Advisers, published an editorial in the Wall Street Journal titled "*The Debt Crisis Is Coming Soon*" and subtitled "*To avoid economic distress, the government has to reduce future entitlement spending*." On May 30, 2018, Ohio Governor and former Congressman John Kasich published in the same paper an editorial titled "*Entitlements Will Eat America's Economy*" and subtitled "*As we did in the 1990s, lawmakers should put aside partisanship and get to work on reform*."

Prudent Management Associates does share these concerns, although we have not, to date, concluded that they should affect our investment decisions. Nevertheless, not all economic observers accept Greenspan's "sky is falling" hypothesis, most notably Warren Buffett, who wrote this in his Annual Report to Shareholders released in February 2019:

> Those who regularly preach doom because of government budget deficits . . . might note that our country's national debt has increased roughly 400-fold during the last of my 77-year periods. That's 40,000%! Suppose you had foreseen this increase and panicked at the prospect of runaway deficits and a worthless currency. To 'protect' yourself, you might have eschewed stocks and opted instead to buy [gold] . . . . And what would that supposed protection have delivered? You would now have an asset worth . . . less than 1% of what would have been realized from a simple unmanaged investment in American business. The magical metal was no match for the American mettle.
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> Our country's almost unbelievable prosperity has been gained in a bipartisan manner. Since 1942 . . . the country contended at various times with a long period of viral inflation, a 21% prime rate, several controversial and costly wars, the resignation of a president, a pervasive collapse in home values, a paralyzing financial panic and a host of other problems. All engendered scary headlines; all are now history. . . .
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> Charlie and I happily acknowledge that much of Berkshire's success has simply been a product of what I think should be called The American Tailwind. . . . Over the next 77 years . . . the major source of our gains will almost certainly be provided by The American Tailwind. We are lucky – gloriously lucky – to have that force at our back.

While Warren Buffett is not, of course, infallible, only the most immodest of persons would take these words lightly and blithely decide to bet against him on these issues.