21ST-CENTURY WAR ECONOMICS

BY GEORGE GILDER
AND BRET SWANSON

"The Republicans don't have a clue how bad the economy is," a Democratic congressional aide told us one late October night, savoring the vision of a gavel in Dick Gephardt's hand. Then, slowly, he broke into a wide smile, like a happy hijacker dreaming of seventy succulent virgin interns awaiting him in paradise.

Chiefly in the business of appraising enterprise and technology, we do not visit Washington often these days. But with deflation and depression now ravaging our domains, we decided to make an expedition to the source of the problem. During a week walking down those benighted corridors, we were amazed by the depths of ignorance we found. Nearly no one in the city had any idea of the dire condition of the enterprises and technologies that will be indispensable to winning a war.

The cosseted, cretinous world of Washington economics and media punditry sees economic growth as an effect of the Prozac of "consumer confidence" and government spending. It imagines that seven trillion dollars of wealth can disappear because of bubble-headed investors rather than bubble-headed policy makers. Congressional pundits aver that all we need to overcome a deflationary spiral is avid avoidance of permanent tax rate reductions and artful application of stimulus from the dildonic pen of Paul Krugman.

As late as November, Washington sages still expected an economic recovery based on the socialist sorcery of Robert Rubin and the tricks and trichinosis of House and Senate budgetary bacon and pork. Is it $75 billion? $100 billion? $150 billion? Oh, well. Meanwhile gassing up the nation in a blinding kultursmog is an asinine illusion of the media and the academy, voiced obsessively by every wealth-hating intellectual from the *New Republic* to Pat Buchanan. Prosperity, we are told, comes from taking money and benefits from productive and ingenious people—thus reducing their productivity and investment—and giving it to tax avoiders, thus ensuring that they stay out of work.

Washington wants to win the war against terrorism by sucking funds out of the technology sector and endowing indolence, even while we hurl every Third World country and debt-fuelled technology startup into a deflationary pit. With commodity prices from coffee to cotton at 15-year lows, deflation is sinking Pakistan, Turkey, Argentina, Brazil, Venezuela and Colombia. U.S. monetary policy and IMF-sponsored tax hikes are enhancing the power of desperadoes everywhere and imperiling any alliance against the terrorist jihad. Real interest rates—also at all-time highs, corrected for deflation—imperil half the world's telecom industry, from Deutsche Telekom to Global Crossing. Yet Washington clowns and financial filberts still warn about inflation, and Milton Friedman says all is well because the hoarding of cash is jacking up the money supply numbers. Alan Greenspan is not sure that the global deflation that began in 1996 is real, even today.

In key technology sectors, capital spending has sunk some eighty percent. Semiconductor sales have been halved since autumn 2000. Our most innovative fiber optic equipment firms now exhibit revenue half-lives of about three months. Running at $10 billion a month, defaults by Internet carriers are helping push bankruptcy levels to record highs. Even the producer price index, one of the foggy rear-view mirrors Washington favors, has just plunged 1.6 percent in a single month, the largest drop since 1947. Forty percent officially—but in reality more than one hundred percent—of our economic growth since 1995 derives from technological advance. A high-tech collapse portends not mere recession but depression.

From the iron stirrups of the Vandals and Goths and the long bows at Agincourt to the atomic bombs and the Turing Bombe computer that cracked Hitler's Enigma code, wars are always decided chiefly by technology and the culture that supports and uses it. [See "Why the West Has Won," p. 60] Where there is a way there is a will. From biotech and satellites to neural nets and smart bombs, from optics and high energy microwaves to antibiotics and biotech, technology can enable us swiftly to identify and subdue the forces of terror and chaos ascendant in the world. Under widespread development but in need of aggressive adaptation to martial needs, these tools of war comprise our chief advantage against terrorism. They can obviate scores of thousands of deaths in battle and millions of civilian casualties. As Peter Huber put it in an incandescent speech at our Telecosm conference in San Francisco in early November, we can apply "our silicon against their sons."

As Huber also pointed out, the private sector will develop and deploy much of this technology without any government aid. Insurance companies will require every building and mall and other public space to know who enters it and what is in every box and bag and SUV that passes over its portals. Private citizens will require their physicians to give them protection against biowar. Travelers will demand automated systems for screening luggage rather than merely harassing citizens. The result will be a new technology boom.

Confronting this rise of invention and enterprise, however, is a countervailing force of destruction from the public sector: the purblind economics of envy and class hatred, barring any policy that favors the accumulation of capital by entrepreneurs who can invest it productively in these very same crucial fields.

In Washington even the Republicans mill around like a herd of hornless Guernseys, prodded by the press and the polls to thwart any moves aiding the elite of entrepreneurs and technologists who can deliver relevant

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weapons. At a time of acute need for new antibiotics and anti-viral drugs, Tommy Thompson proudly threatens Bayer with suspension of its Cipro patent, for the offense of developing a drug useful against anthrax. At a time the nation needs steel for weapons, Administration vertebrae melt under protectionist lobbying. House leaders staunchly defend market freedom for those economic prime movers, the airport metal-detector technicians, then allow Democrats and lobbyists to write the far-reaching tax bill. Addressing conservatives at a recent weekly luncheon, one Republican senator failed to find a place for the economy among his three top priorities; adding it to the list would only dilute efforts to confirm new federal judges, he said. Oklahoma's stalwart Don Nickles and a few Senate colleagues were accordingly reduced to Daschle damage control.

On tax cuts, Republicans failed to champion the obvious truth that lower marginal tax rates yield greater economic output and government revenues. In a leadership vacuum, they instead adopted former Clinton Treasury Secretary Rubin's enematic idea that tax cuts push up long-term interest rates and choke off investment. No one mentioned mounds of contrary evidence from every corner of the globe. Bush advisor Glenn Hubbard finally exposed Rubin's crank notion, but only after the stimulus cake full of empty Keynesian calories was seven-eighths baked.

Everyone in Washington blames business first. It is the bubble theory extended beyond day-traders. And conservatives are fond of it. If we hadn't climbed so high, we wouldn't have so far to fall. Too many junk bonds. Too much Valley capital. Too many greedy bankers and importers of cheap foreign steel and machine tools. Too many twenty-year-old dot-commers who forgot to bring the business plan. Too many chips. Too much fiber. Too many cool but irrelevant gadgets. Yes, there have been gross missteps—that is how capitalism works. But the gleeful politicos' hunt for alibis is chiefly to avoid acknowledging systemic economic problems caused in Washington itself.

They ignore real inventions and real value created over the last half-decade. Astounding number: a communications network built with 1995 technology capable of carrying world Internet traffic at 2000 levels would cost $8.7 *trillion*. This year the figure would run closer to $20 trillion. Moore's law of microchips, the driving force of the last two decades of growth, continues apace, and optical technologies are advancing two or three times as fast. The boom was real.

So is the bust. Throughout both cycles Alan Greenspan has been in denial. In between hip if muddled musings on the New Economy, the one-time Randian told us the stock market rose not because of new value creation but because we were greedy. Inflation was a threat not because of anything the Fed might do but because we were growing too fast. Later briefly indicted as the inflation-inducing culprit was productivity (don't ask and we won't tell you the contorted tale). Then an inventory glut emerged as the cause rather than the result of the slowdown. Now September 11 clouds our economic future. Anything but Washington.

Nobel Laureate economist Gary Becker argues in the *Wall Street Journal* that the U.S. will recover quickly from September 11 because we retain our knowledge and skills. He cites Japan's "recovery" after the horrendous 1995 Kobe earthquake, and is right such events do not disable the real engines of growth. But our economic problems far pre-date September 11. Like Japan, our economic problems are not two percent the result of physical disaster. Like Japan, we are in the grip of a wrenching deflation that so tilts the balance between debtors and creditors that our capital markets had long been frozen. Seven trillion dollars of new wealth were blown away. The Japanese have yet to recover from their own decade of deflation, and still their Hooverian central bank warns of inflationary peril.

September 11 is now an excuse—in Psych 101-speak, an enabler. It gets Larry Lindsey, Alan Greenspan, and Congress off the hook. It masks the true systemic forces undermining the global economy: deflation, the highest and most paralytically complex tax burden since World War II, and crippling antitrust and telecom regulation.

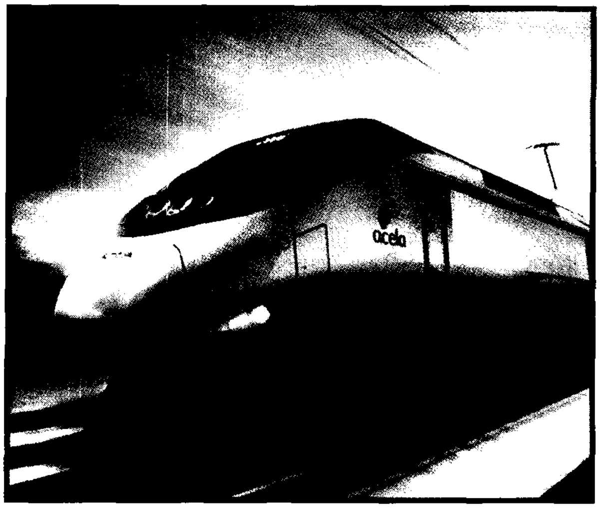
That most have failed to grasp deflation as part of this equation is understandable. Not only has it fooled policymakers, but it has also swallowed some of the nation's best business managers. Former Microsoft CFO Greg Maffei led 360networks off the precipice of debt; former AT&T number two Alex Mandl did the same at Teligent; as did former IBM and National Semiconductor executive Ellen Hancock at Exodus.

Deflation has hobbled Japan for a decade and demolished the airline, auto and telecom industries. Because it is so rare, and because it mimics inflation, deflation—nothing more or less than an insufficient supply of money—is inconspicuous. In an inflation, the government prints too much money. In a deflation, people and firms hoard scarce money in risk-averse accounts more likely to be included in government M statistics. Unlike inflation, however—where people quickly spend their depreciating dollars—a deflationary rise in the Ms is coupled with much slower money turnover. The economy needs more money to sustain even diminished economic activity. The famous monetarist Friedman, who assumes constant velocity, warned recently of imminent inflation. But today, with some seventy percent of all dollars circulating overseas, the monetary Ms are nearly irrelevant. Even as the Ms expand at record pace, real liquidity—signaled by plunging spot commodity prices—is not rising.

Likewise, a lame and lagging indicator is the consumer price index. Automobile sticker prices are not falling, but ubiquitous zero percent financing has the same effect. Big Three incentive packages, averaging $2,400 in October, are $1,000 more than a year ago. Annual sales of 16 million vehicles, therefore, means reduced Big Three revenue of $16 billion. "That's almost double the combined pre-tax earnings last year of Ford, Chrysler and General Motors," said Saul Rubin of UBS Warburg in *Barron's*. "The Big Three are going to post tremendous losses for the foreseeable future," writes analyst Michael Churchill of Polyconomics. "The auto industry provides an excellent illustration of why and how deflation trumps interest-rate cuts in terms of their impact on the economy."

To every man and nation comes a moment to decide whether to embrace reality and truth, however harsh and harrowing, or to indulge in evasions and alibis. Cleaving the global economy like a titanic force of nature are two imperious trends. Originating in the private sector, one is overwhelmingly positive and redemptive: the ever accelerating advance of technology. But it faces a powerful force of negation and decline.

In times of peace and prosperity, politicians can cavort with interns, pollsters and astrologers. But in crisis leaders must emerge to tell the truth about real perils and possibilities. Which of the two conflicting trends in Washington wins will determine the outcome of the war against terrorism, the future of capitalism, and the survival of freedom. Bill Clinton's presidency exhausted the room for error and demagoguery. The time has come for President Bush to combine his leadership in the war against terror with leadership in the drive against depression.



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IN HALF—STILL

NO CEASE-FIRE ON BIG GOVERNMENT

BY GROVER G. NORQUIST

Two weeks after the terrorist attacks on New York City and the Pentagon, a *Wall Street Journal* front-page story announced: "Terror Attack Reverses a Two-Decade Drive to Shrink Government." Albert Eisele, the publisher of *The Hill*, headlined his version, "The End of the Republican Revolution." The *New York Times* editorialized that the attacks had turned George W. Bush into a "moderate."

Does Osama bin Laden's handiwork mean Big Government is back?

No. But its friends won't fail for lack of trying. Prior to Sept. 11, White House budgets projected that federal spending would drop from 18 percent of GDP to 16 percent over the next decade. Since then, House and Senate appropriators have voted for new spending initiatives totaling $251 billion—$70 billion for money-losing Amtrak alone. Both houses quickly passed a 342-page collection of new federal police powers, in the name of fighting terrorism. The Senate voted 100 to zero to nationalize the 28,000 underwear inspectors at airports. Liberals are cheering polls that suggest the public now has more trust in the federal government.

The conservative consensus on shrinking government—now facing this concerted counterattack—is a relatively new phenomenon. Since the end of the Second World War, conservatives have had two pole stars: opposition to communism globally and to deficit spending at home. These were measurable efforts; one could judge a president's foreign policy by how many countries fell to the Red Army on his watch. Ronald Reagan's victory over the Soviet Union, ironically, removed this central organizing principle of the Right. It is now much more difficult to measure how an administration is managing national defense. We know now that there were major intelligence and foreign policy failures during the Clinton years, but it was hard to measure at the time.

Deficit spending has been the Right's other great touchstone. In the 1950s conservatives attacked it, even when their real agenda was to limit the size of government; they felt the case was stronger when linked to Americans' aversion to debt. From the other side, liberals argued that deficit spending was in fact an unmitigated good—John Maynard Keynes wrote a whole book on the subject. But by the 1980s they discovered that they could block Reaganite calls for tax cuts by publicly opposing "deficits." They dropped the noun "spending" and used their opposition to "deficits" as a weapon against tax relief and in favor of "revenue enhancements."

Measuring economic policy by "deficits" was a disaster for conservatives. State and local spending ballooned. And the massive spending binges of Bush's 1990 budget and Clinton's in 1993 were implausibly pronounced "deficit reduction measures"—they just tacked on tax hikes, too. Pity the poor voter who listened to both parties. Republicans wanted to spend less. Democrats wanted to tax more. Their rhetoric told voters they were in agreement.

The 1994 GOP congressional sweep brought modest spending

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