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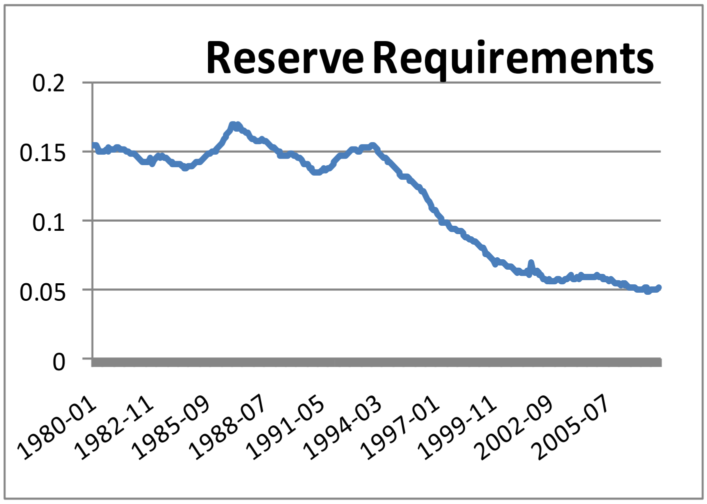
THE VIEW

"Inferiors revolt in order that they may be equal, and equals that they may be superior. Such is the state of mind which creates revolutions" - ***Aristotle***

Clinton Success … An Obama Mistake?

The Omnibus Reconciliation Act of 1993 that President Clinton signed into law in his first year as president was feared at the time to put undo fiscal pressure on an economy just emerging from recession. It was argued that the tax increases would impede growth by placing a particularly large burden on the wealthiest Americans that created new jobs. In hindsight it appears that the skeptics were wrong, and the law had been widely hailed as being effectual in bringing down the government deficit and creating a surplus by the time Clinton left office.

This seems to be the exact playbook the Obama administration is working from in hopes for a repeat performance. That being the case, it makes sense to review the circumstances surrounding President Clinton's success and if it is likely to be repeated. Two very important factors that may or may not have entered the minds of the Clinton administration and Federal Reserve Chairman Greenspan are the secular decline in interest rates at the time and the bank *capital reserve requirements*. The second of these is extremely important to understand. Against the headwinds of higher taxes, the administration needed a tool to offset the resulting drag. Lower rates would provide some ballast, but they needed more. Enter bank capital reserve requirements. Look at the chart below. Starting in 1993 the capital reserve requirements for banks were relaxed slowly and methodically right until Clinton left office in 2001. This, coupled with lower interest rates, made the powerful elixir that allowed the economy to roar ahead *in spite of* higher tax rates.



By lowering the reserve requirements, bank capital was freed up to be lent, and lend they did. Credit creation for both productive and non- productive activities flourished. So much so that we've witnessed some of the largest asset bubbles ever created as a result. By way of explanation, if the banks had capital reserve requirements of 15%, they could leverage their assets by roughly 6.5X. Comparatively, if their capital reserve requirement was only 5%, they could leverage up to 20X. The increased ability to lend money has a multiplier effect that is important to *money creation,* and with that growth in available money the price level for assets increased (think housing and stocks). This lower reserve requirement along with an incentive to borrow (*low interest rates*) has put us in a very precarious position, indeed.

Arguably, the Obama administration will not experience anything close to the results that the Clinton era, with it's tax increases, witnessed. It would be hard to argue that interest rates would continue to go much lower from here. Even if they did they would have a much more muted effect on the economy. More importantly, new capital rules for banks (including other regulations recently passed into law) will likely have a dampening effect on bank lending going forward. So the two paramount conditions for President Clinton's successful tax policy will not exist for President Obama. A different set of circumstances will produce very different results!

A good corollary to this is George W. Bush's policy prescription during his presidency. In broad strokes it largely mirrored Ronald Reagan's governing philosophy. It included a large tax cut early in his first term similar to Reagan's. It was heavily geared toward a military buildup, largely reversing Clinton's general neglect (though both Reagan and Bush had differing reasons for doing so). At the end of the day, however, the Reagan presidency has been viewed generally favorably, while George W. Bush's has been deemed to have failed. It can be argued that the difference was in each man's delivery and communication with the public. The policies were keenly similar, however.

As is often the case, we need to take into account the circumstances surrounding our decisions. What looks like a good set of principles because they have worked in the past, may not be the best set given changing circumstances. This goes for politics, investing and even raising our children.

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