CHAPTER 1

HISTORY 101

From 13 Colonies to Global Economic Power

Histories make men wise.

—Sir Francis Bacon

To fully understand where America's economy is going in the future—and how you can best profit from that journey—you really need to know how it got to where it is today. However, since I'm sure you didn't intend to sign on for a history degree when you picked up this book, I'll do my best to keep it brief.

Boil the economic development of the United States down to 25 words or less, and it comes to this: Adversity happens. People adapt. Innovation pops. Wealth results.

That's it—with 17 words to spare.

Wise men say there's no better teacher than experience, and U.S. history assures me, time and again, that no matter how bad things get, they *will* get better, leaving us with even more chances to achieve even greater wealth than we ever had before.

To prove it—and begin getting you back on the road to personal financial recovery—I want to start back at the country's beginnings, track the emergence of U.S. economic power over the last 300 years, and review the actions earlier investors took to overcome their challenges and reach the next level of prosperity. (Unbeknownst to most modern investors—and the majority of Wall Street "pros"—U.S. hegemony actually dates back to pre-Colonial days.)

Then, we can strategize proactively on how to catch the next monster-wealth wave—moving on to Parts II and III of this book, where I detail some of my preferred investment strategies, share some of the "dirty little tricks of the trade" I regularly employ, and offer some specific recommendations to help you more wisely and successfully navigate your way in today's perilous financial waters.

IN THE BEGINNING, THERE WAS . . .

The modern American economy traces its roots to the quest of European settlers for economic gain—not just religious freedom—in the sixteenth, seventeenth, and eighteenth centuries. Actually, Vikings were the first Europeans to "discover" North America, in the year A.D. 998. A Norse sailor named Bjarni stumbled on Greenland after being blown off course on his way to Iceland. But, since the Viking livelihood, like most of Europe's, was then centered primarily on agriculture, land ownership, and the occasional pillaging and plundering, the possibility of expanding Scandinavian trade really wasn't foremost in their minds. Land-grabbing and settlements were—but, in the end, they abandoned even that.

Fast forward about 500 years to 1492, when Christopher Columbus—an Italian sailing under a Spanish flag (investors were thinking multinational even then)—chucked the idea that the world must be flat and sailed forth to find a southwest route to the spicy-priced goods of Asia.

Surprise! Columbus bumped into a "New World" instead—igniting a 100-year "place race" of exploration by the English, Spanish, Portuguese, Dutch, and French, all trying to beat one another out in their pursuit of gold, silver, and untold other riches.

Unfortunately, early explorers found little more in North America than some crazy weather, what today is prime beachfront property, and tribes of indigenous peoples, whom they mistakenly called "Indians," thinking they had actually reached India instead of a strange New World. These indigenous Americans enjoyed simple lives, engaging in hunting, gathering, and growing. They traded among themselves and had virtually no contact with the rest of the world before their economies were profoundly and forever altered by the arrival of their "discoverers" and the ensuing influx of European fur traders, firearms, and other wares.

Early colonists had scores of reasons for coming to the Americas—led by the Pilgrims, who famously sought to escape religious persecution. But it was the opportunity for economic advancement that brought most European colonists to the New World. In fact, colonies such as Virginia, founded primarily as business ventures, capitalized nicely on the dovetailing of piety and prosperity.

Governor William Bradford of Plymouth Rock fame, operating in survival mode in the midst of a killer first year, decided to embrace the idea of "individual initiative"—the forebear (or underlying principle, if you prefer) of true capitalism. He harnessed the power of the Puritan work ethic and granted each family its own plot to farm, a seismic shift in economic thinking for 1620. Changing the economic rules from communal to private farming allowed everyone—religious zealot to adventurer to indentured servant—equal opportunity to reap the rewards of their own hard labor (or lack thereof) instead of settling for a proportionate share of the whole. And it worked!

Later, England's brilliant use of charter companies to settle the New World gave each group of stockholders—usually merchants and wealthy landowners—a vested interest in making its colony a thriving economic success. They also got political and judicial powers—and the undying gratitude of their King for furthering his own expansionist agenda.

The system experienced a hiccup when many of the monied investors, quickly tiring of life in a luxury-free wilderness, withdrew back to England, abandoning their charters to settlers, who basically had to figure out how to build something out of nothing—or starve.

Once again, individual initiative grabbed hold and marginally successful farms became hugely profitable by raising highly addictive crops like sugar and tobacco. British demand for colonial crops skyrocketed, "American entrepreneurialism" soared and a brave, new middle-class America emerged.

BIRTH OF A CONSUMER NATION

Soon, specialized mills, shipyards, and iron forges developed to support growing trade. By the eighteenth century, standards of living in the 13 colonies (except for slaves) outstripped those in England. New World prosperity fueled a fierce desire for greater autonomy. As Bradford had recognized 150 years earlier, the people who did all the heavy lifting wanted to enjoy the fruits of their labor—and have a say in how those fruits were spent.

However, that was impossible under the Navigation Acts imposed by Britain in the mid-1600s. The laws, based on the economic system of mercantilism (colonies exist only to serve the Mother Country), decreed that only British ships could carry colonial goods and all exports and imports had to be sold or purchased through Great Britain. Adding insult to injury, colonial manufacturers were forbidden to compete directly with British manufacturers.

The colonists chafed at their wallets. Mother England was increasingly perceived as corrupt and hostile to American economic interests. By 1770, colonial "consumer politics" erupted into open protest against "taxation without representation." Boycotts were creatively staged (think Boston Tea Party) and trade parity was demanded.*

When England refused to be moved, the Revolution was on. The "sovereign United States of America" proclaimed independence on July 4, 1776, in a Declaration that its chief composer, Thomas Jefferson, penned as a singular "expression of the American mind."

The rest, as they say, is history.

---

*History shows that it was actually Chinese tea that American revolutionaries threw into Boston Harbor in 1773. Daniel Burstein and Arne de Keijzer, *Big Dragon* (Simon & Schuster, 1998), 29.

LIKE THE ECONOMY, FEWER CELEBRATIONS SPARKLE

The roots of America's recent financial problems may not reach all the way back to the founding of our country in 1776, but those troubles have certainly affected our commemoration of that historic event. The skies were quite a bit darker on the evening of July 4, 2009, as budget shortfalls forced nearly 50 communities around the country to cancel their public fireworks displays, and many more had to turn to private donations to fund their celebrations. Still other communities chose to show their patriotism in a way more appropriate to the hard times. Montebello, California, canceled its fireworks display and donated the $40,000 the show would have cost to groups distributing food to the needy.

THE INDUSTRIAL REVOLUTION—GO WEST, BY TRAIN, SAY BUY!

The Industrial Revolution arrived almost simultaneously with the end of the American Revolution in 1783, pulling the new nation away from its agrarian roots and pushing it toward industrial domination. But first, after eight years of tortuous warfare, the Founding Fathers needed a prosperity plan.

A national bank was established to assume the public debts incurred (mostly to France) during the war. The Constitution, adopted in 1787, empowered our government to ban taxes on interstate commerce, regulate foreign and domestic trade, create money and set its value, fix standards of weights and measures, and grant patents and copyrights. These new national powers—conceived by the Constitution's primary author, James Madison—were designed to tell the world that America was now one big unified and rapidly growing market.

The advent of industrial machines revolutionized the U.S. economy (and the world) in the late 1700s and early 1800s. It brought major changes to agriculture, manufacturing, mining, printing, and transportation—and major wealth to industrialists and middle-class entrepreneurs who quickly adapted the new technologies. Steam-powered manufacturing made water-powered plants obsolete, freeing up industries previously fettered to the rivers of New England to relocate anywhere they pleased.

Even ordinary laborers benefited on the mass production lines of transformed urban centers. Granted, they suffered under harsh working conditions, and protections against child labor were virtually nil, but concentrating workers into sweatshops and factories soon spawned trade unions, which were organized to improve working conditions and wages through collective bargaining.

Eli Whitney's invention in 1793 of the cotton gin turned a chump-change Southern crop into a booming international market. Wealthy planters bought up land from scratch farmers who, in turn, chose to head west. There, they joined thousands of Yankees who yearned for more fertile Midwestern farmlands rather than rocky Nor'eastern hills.

To facilitate migration and underwrite emerging new agricultural markets, the federal government paid for new national roads and waterways such as the Cumberland Pike (1818) and the Erie Canal (1825)—adding an additional stimulus to the young nation's economy. As new territories were acquired—from Texas to California—technology developed to support expanding domestic trade.

Railroads, in particular, rocked the status quo, opening up vast new American vistas for development. Between 1850 and 1890, rail mileage increased a whopping 1,300 percent (from 9,021 miles to 129,774), transitioning the United States from an agrarian society into an urbanized industrial nation—and turning the men who owned those rails into millionaires. Consequently, railroads attracted huge domestic and European private investment, as well as large government subsidies in the form of land grants. Train barons, by necessity, had to reinvent how to run large-scale enterprises and deal with managerial complexities, labor unions, and competition—in effect creating the blueprint for modern-day corporations.

THE CIVIL WAR AND RECONSTRUCTION

Despite the changing landscape, urban industry still defined the Northeast and rural farms the South. The South depended on the North for capital and manufactured goods; the North relied on the South for cotton for textile manufacturing, but little else. So, to maintain some semblance of trade balance, Southern economic interests required cheap labor. Unfortunately, slavery was the only economic option that fit the bill. Thus, when President Abraham Lincoln called for ending the expansion of slavery and instead expanding industry, commerce, and business, the South rose up and the American Civil War ensued (1861–1865).

War is tragic, but it's also profitable—especially for diversified, industrialized states. The North had the advantage in terms of industrial strength and resources, and could easily convert commercial manufacturing to military production. The South, more isolated and dependent on a single cash crop, had no real war-ready reserves to draw upon.

The North won, the slaves were freed, plantation-driven economics were destroyed, and Northern industry, which had expanded exponentially thanks to wartime demands, surged ahead. Reconstruction followed, with a host of new (and highly controversial) policies designed to restore the American (not just Northern) Union, rebuild the South, and "fix" the Constitution. The latter required formally abolishing slavery and electoral discrimination, and instituting provisions to educate former slaves.

FISCAL FLASHPOINT

The Civil War foreshadowed how important the "military-industrial complex" would eventually prove to be to America's modern economy, even though that term wouldn't actually exist for nearly a century. It was ultimately coined by President Dwight D. Eisenhower, a five-star general and Supreme Allied Commander during World War II, to describe the infrastructure needed to engage in the Cold War.

THE GILDED AGE OF INVENTION, DEVELOPMENT, AND TYCOONS—1865 TO 1900

America returned to the gold standard in 1879, creating an acceleration in money growth as a direct result of the flow of new gold. The Gilded Age sparked a period of deflation, an explosion of inventions (cars, telephones, radios, and airplanes), and the rise of the *tycoon,* when every man could be a potential Andrew Carnegie.

Discoveries of massive coal deposits in the Appalachian Mountains and fields of "black gold" and iron across the Midwest stoked the fires of the nation's industrial infrastructure. Men who were quick to see the inherent potential for new services or products—men like John D. Rockefeller in oil, Jay Gould in railroads, J. Pierpont Morgan in banking and, yes, Carnegie in steel—amassed vast financial empires.

The new Americans—hardy individualists and unsophisticated risk takers who had flocked to the New World to create their own destinies—enthusiastically embraced money-making. They were also quick to flaunt their flamboyant lifestyles—much to the chagrin of the more rigidly class-conscious Europeans. "Diamonds may be a girl's best friend," British nobility would sniff, "but they don't belong around the neck of Mrs. Stuyvesant Fish's pet pooch." But when, by the late 1880s, the United States surpassed Great Britain as the globe's most powerful economy by more than two-to-one, the world had no choice but to take notice.

In spite of its growing economic power, the United States didn't engage in any territorial empire building in the final days of the nineteenth century, mostly because imperial rule seemed inconsistent with America's democratic principles. It did, however, pick up several new territories—annexing Hawaii in 1898, then getting Puerto Rico, Guam, the Philippines, and Cuba from Spain following the Spanish-American War (though Cuba was quickly granted independence in 1902).

And, as the new century dawned, it also began to show increasing foreign-policy assertiveness around the world.

GROWTH, GOVERNMENT INTERVENTION, AND THE GREAT WAR: THE PROGRESSIVE ERA—1890 TO 1920

Before 1900, most American politicians were reluctant to intervene in the private sector, except when it came to transportation. *Laissez-faire*—a government-hands-off-the-economy doctrine—generally guided policy making. However, as the developmental pace of industrial technology steadily increased, middle-class entrepreneurs—weary of fighting corrupt officials, cutthroat tycoons, radicalized farmers, and labor movements—pressed for government regulation to protect competition and free enterprise.

They found sympathetic ears in Presidents Theodore Roosevelt (1901–1909) and Woodrow Wilson (1913–1921). Before they came to power, Congressional laws regulating railroads (Interstate Commerce Act of 1887) and monopolies (Sherman Antitrust Act of 1890) went rigorously *unenforced*. Roosevelt put new teeth into those laws, and also established the Food and Drug Administration (FDA). Wilson followed with creation of the Federal Trade Commission (FTC), and also contributed to two other acts destined to foster our eternal regret:

1. The Sixteenth Amendment to the Constitution, ratified by Congress in 1913, instituted the first federal income tax.
2. The Federal Reserve Act, also passed in 1913, created the Federal Reserve System, or simply the Fed, a quasi-public, quasi-private central banking system intended to deal proactively with bank panics—though its influence since has extended far beyond those original parameters.

The practice of doing business in America was definitely maturing. However, the event having the greatest impact on the U.S. economy arrived in 1914, when imperial European politics spawned World War I. The major European nations, chafing from a prolonged loss of colonial power, had for years been embroiled in a scramble for control of 10 million square miles of Africa (roughly one-fifth the world's land mass). When the conflict finally returned home, it ultimately pulled most of the world's powers into one of two opposing alliances: The Triple Entente (Allies) and the Central Powers (Germany & Co.).

Some 70 million troops were activated in this "war to end all wars," and combatant countries pumped the full scope and range of their scientific and industrial capabilities into the war effort. More than 15 million people died, making this first technology-heavy global conflict the deadliest in history.

It was also one of the most economically devastating. To pay for essential war materials, Great Britain cashed in its massive investments in U.S. railroads and began borrowing heavily on Wall Street. President Wilson—who managed to delay America's entry into the war until 1917—had been parceling out aid to Europe in the early days, but in 1916 allowed for a huge increase in government lending to the Allies, most of which came back to the United States for war purchases. Gross Domestic Product (GDP) soared. All told, America lent the Allies $7 billion during the war—mostly for military equipment, food, and medical needs—and another $3 billion shortly after the war ended.

Once the United States declared war on Germany, a radical expansion of governmental powers ensued. New federal departments, Cabinet posts, and executive powers were created, new taxes levied, and new laws enacted—all designed to bolster the war effort. The nature of the economy also shifted dramatically. With the prime of America's mostly male workforce drafted into military service, an unprecedented number of women took their places—setting the stage for a more modern view of women's role in society and underscoring the postwar case for granting women the right to vote.

THE ROARING TWENTIES AND THE CRASH—1920 TO 1929

With peace restored and Armageddon put to bed, America returned to the business of doing business, this time as a world power tied to other countries by trade, politics, and joint interests. The United States also began to extend its economic reach into the rest of the world. Before the war, foreigners had invested more money in the United States than Americans had invested in other countries—about $3 billion more. World War I reversed that trend.

Increased foreign investment was not the only sign of America's growing financial influence. By the end of World War I, the United States produced and consumed more goods and services than any other country, both in terms of total Gross National Product (GNP) and GNP per person. By 1920, the U.S. national income outstripped the combined incomes of Britain, France, Germany, Japan, Canada, and 17 others. Quite simply, in a few short years, America had become the world's greatest economic power.

Cultural and societal upheaval and an influx of new wealth swept over the United States—and spread to the rest of the world. People swapped out "everything old" for "everything modern." Jazz defined *hot,* flappers defined "the new woman," and excess defined everything else. The Roaring Twenties were on!

Unprecedented industrial growth, inventiveness, and ample credit accelerated consumer demand and significant changes in lifestyle. The slogan "Anything goes!" fit perfectly because anything *did* seem possible with modern technology. When mass production made luxury affordable to most middle-class Americans, cars proliferated, movie attendance skyrocketed, and a newfangled entertainment medium called radio swept the country.

Rapid growth of the auto industry stimulated oil drilling, gas production, and road building. Tourism soared. Consumers traveled farther for shopping. Small cities, big cities—everybody prospered—creating a boom in construction. Electrification transformed business, farming, and everyday life. Telephones became commonplace rather than rarities. And, for the first time, millions of families moved into their own houses and began investing heavily in stocks, borrowing money to do both—simply because they could. (Sounds vaguely familiar, no?)

Of course, all that came to a screeching halt in October 1929 when Wall Street fell apart. In terms of duration and fallout, the

1929 Crash (which was more than a one-day affair) was the most devastating economic event in our nation's history to that point. The catastrophic downturn triggered widespread panic and the failure of banks all across the country, followed by the onset of an unprecedented and devastatingly long Great Depression. Notably, given current events, the Crash came on the heels of a sharp decline in real estate values, which had peaked in late 1925.

THE GREAT DEPRESSION AND THE NEW DEAL—1929 TO 1941

"Experts" still disagree on the precise cause of the Crash, but not its effects. For the next decade, economic contraction gripped the world. It was "fear mixed with . . . disorientation . . . cauterized with denial, both official and mass-delusional," wrote Steve Fraser, author of *Wall Street: A Cultural History*. The Roaring Twenties were roaring no more.

There was absolutely nothing selective about the Great Depression, the impact of which lingered until 1940 and affected everyone, rich and poor—and with devastating global effects. The worldwide impact was doubly painful to the United States because a revolving system of German reparations collapsed in 1931 and most of the $10 billion the United States had lent to Europe for World War I was never repaid.

International trade plunged by one-half to two-thirds, as did U.S. personal income, tax revenue, commodity prices, and corporate profits—if the companies even managed to stay in business. Cities that depended on heavy industry were hard hit. Construction came to a virtual standstill. Crop prices fell by roughly 60 percent, forcing many farmers to abandon their fields. With consumer demand plummeting, total unemployment hit 23.6 percent by 1932—with even worse numbers in heavy industry, lumber, agricultural exports, and mining.

Desperate times called for innovative thinking, and Franklin D. Roosevelt brought that to the Presidency in 1933. He balanced the regular budget, but increased the emergency budget (funded by debt) from 33.6 percent of GNP to 40.9 percent. A patchwork of new public-sector programs—known collectively as the New Deal—was instituted in an effort to alleviate the crisis. One of those was the radical—some would say socialist—Work Projects Administration (WPA), which put millions of unemployed Americans to work.

The New Deal also extended federal authority over banking, farming, and welfare; set minimum wage-and-hours standards for private employers; set up the Securities and Exchange Commission (SEC) to regulate the stock market; established the Federal Deposit Insurance Corporation (FDIC) to guarantee bank deposits, and created the Social Security Administration (SSA) to provide assistance for the elderly.

Innovation also grew in the private sector, where companies like Procter & Gamble survived by pursuing new advertising avenues, such as sponsoring radio shows. Movie theaters kept their doors open and seats filled by installing air conditioning, using giveaways, and offering cash door prizes. Breweries—still suffering the morning-after effects of Prohibition—diversified into dairy production and other agricultural enterprises.

The upshot? America began to show early signs of renewed economic health by late 1934, matched many pre-Crash numbers by 1936, and was almost fully recovered by 1940. (GNP was 34 percent higher in 1936 than in 1932, and 58 percent higher in 1940.) Then, to complete the recovery, along came World War II.

STRICT CONTROLS AND A WARTIME BOOM—1941 TO 1945

With no small amount of foresight, the New Deal also created power-sharing departments among three key economic players—the government, the military, and business—to better coordinate on matters of national security. As a result, when World War II broke out, America was prepared—just as a world power should be.

The War Production Board coordinated national productivity to meet military needs—for example, converting auto manufacturing plants to wartime production of tanks and aircraft. Similarly, the

Office of Price Administration set rents and rationed scarce products like sugar and gas to prevent rampant inflation.

With massive spending, strict price controls, War Bond sales campaigns, rationing, raw materials management, prohibitions on new housing and new automobiles, guaranteed cost-plus profits, subsidized wages, and the draft of 12 million soldiers, the United States quickly turned into the "Arsenal of Democracy" that Roosevelt had envisioned—one that could stand against the Axis powers of Germany, Italy, and Japan.

Given those efforts, it's not surprising that prices remained comparatively lower during World War II than they had during World War I, helping the economy grow another 56 percent between 1940 and 1945.

Anyone, anywhere, with a company and a plan for converting to wartime production made money during that time—though, in a preview of some of the more recent complaints about poor business ethics, there were more than a few charges of war profiteering.

POSTWAR PROSPERITY—1945 TO 1963

From the end of World War II to the early 1970s, American capitalism enjoyed a golden era. Many Americans had feared that the drop in military spending after World War II might revive the Great Depression. However, pent-up consumer demand fueled exceptionally strong economic growth in the postwar period. The auto industry successfully converted back to producing cars, and new industries such as commercial aviation and electronics grew by leaps and bounds.

A housing boom, stimulated in part by easily affordable mortgages for military veterans, added to the expansion. Gross Domestic Product (GDP) rose from about \$97 billion in 1940 to \$273 billion in 1950 and close to \$520 billion in 1960. (And, as Figure 1.1 illustrates, that rapid growth continued to accelerate all the way to the twenty-first century.) The simultaneous jump in postwar births—the so-called "Baby Boom"—increased the number of consumers and ballooned the ranks of middle-class Americans.

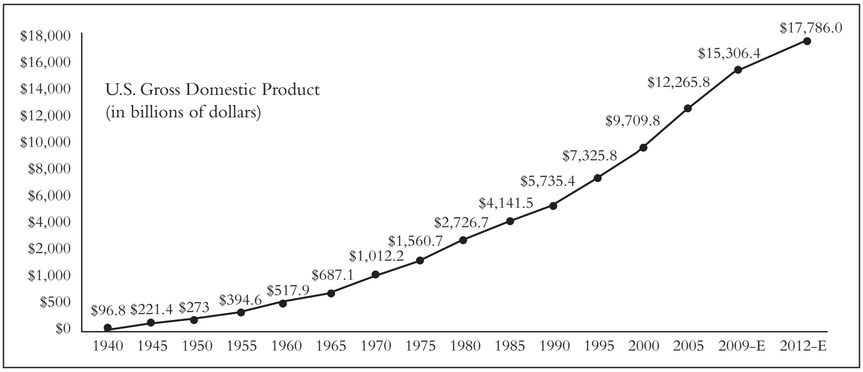

FIGURE 1.1 The Growth of American GDP—1940 to 2012
Sources: White House Office of Management and Budget; Budget for Fiscal Year 2008, Historical Tables.

The need to produce war supplies had given rise to the aforementioned military-industrial complex, and the ties between business and the military did not disappear with the war's end, due in large part to the descent of the Iron Curtain across Eastern Europe. Despite intense "guns or butter" debates, the U.S. government—embroiled in a new Cold War with the Soviet Union—chose to maintain a substantial fighting capacity (also needed to support the Korean Conflict) and invest in advanced weapons, such as the hydrogen bomb.

As President Dwight Eisenhower took office in 1953, ushering in a decade of peace, American business entered a period of consolidation, with smaller companies merging to create large, diversified conglomerates. The U.S. workforce also changed significantly. In the mid-1950s, the number of U.S. service providers surpassed the number of manufacturing workers and, by 1956, a majority of U.S. workers held white- rather than blue-collar jobs. In spite of the move by workers out of factories, though, labor unions continued to gain strength.

Farmers, by contrast, faced tough times. Gains in productivity led to agricultural overproduction and lower crop prices. Farming transformed into a big business enterprise, making it increasingly difficult for small family farms to compete. More and more farmers left the land—and, as a result, the number of people employed in the agricultural sector, which stood at 7.9 million in 1947, began a steady decline. By 1998, U.S. farms employed just 3.4 million people—a 56.9 percent decrease.

Other Americans were also on the move. Growing demand for single-family homes and ever-increasing car ownership led to a migration from central cities to suburbs. Technological innovations—effective and affordable air conditioning being a major one—also spurred surges of development in Sun Belt cities like Phoenix, Houston, Atlanta, Miami, and other Southern and Southwestern locales. As new four-lane highways and interstates created better access to the suburbs, business patterns began to change as well. Shopping centers multiplied, growing from just eight at the end of World War II to 3,840 in 1960. Many industries soon followed, leaving decaying inner cities for newer and less-crowded suburban "business parks."

REVOLUTION, ACTIVISM, AND TURMOIL—THE SIXTIES AND BEYOND

Civil rights. Women's rights. Anti-war. Cold War. Iron Curtain. Counterculture. Che Guevara. Hari Krishna. IRA. SLA. Space race. Human race. Black Power. Flower Power. Cultural evolution. Sexual revolution.

Welcome to the Sixties—when the only thing that changed was everything.

Globally, the tumultuous, wrenching, and yet strangely prosperous 1960s kept replaying the same three scenarios over and over: Heavy-duty militarization provoking economic change, violent street protests agitating for political change, and revolutionary thinking activating social change. President John F. Kennedy even ushered in a more activist approach to governing when he entered the Oval Office in 1961. Asking his fellow countrymen to meet the challenges of a "New Frontier . . . of unfulfilled hopes and dreams, a frontier of unknown opportunities and beliefs in peril," he metaphorically launched the United States into outer space and passed the largest tax cut in history to accelerate economic growth.

On Wall Street, stocks overcame the shock of JFK's 1963 assassination and made a bull run from 1962 to 1968, with the Dow Jones Industrial Average hitting 1,000 for the first time in 1966. Productivity and Gross Domestic Product (or purchasing power parity) swelled, as did the ranks of the middle class and consumer demand. The U.S. government even financed some private sector research and development, most notably ARPANET (precursor to the Internet).

But the heavy build-up of the military because of the Cold War and escalating involvement in Vietnam required a monetary policy that conformed to the needs of foreign policy. (More about the increasing ties between U.S. monetary and foreign policy in Chapters 3 and 4.) In short, with Lyndon Johnson now at the helm, the United States elected to finance 70 percent of its military spending with public debt.

Then, under President Richard Nixon, the United States unilaterally withdrew from the gold standard so as to retain flexibility in domestic economic policy. Little did he know that this would be one of the most historically significant and questionable decisions of our lifetimes, as evidenced by the current crisis. But I'll have more on that later.

During Johnson's tenure, from 1963 to 1969, federal spending increased dramatically as he introduced the Great Society, launching new programs such as Medicare (health care for the elderly), Food Stamps (food assistance for the poor), and numerous education initiatives. Vietnam also mushroomed into a major military conflict but, ironically, spending for the two wars—on poverty at home and on Communism in Vietnam—brought prosperity in the short term.

That changed under Nixon. *Stagflation,* an epic combination of continuing inflation and stagnant business activity, coupled with rising unemployment, gripped the nation—and the government experimented with wage-and-price controls. America's growing dependence on foreign oil also became shockingly clear during the 1973–1974 oil embargo by Arab members of the Organization of Petroleum Exporting Countries (OPEC). Ugly gasoline shortages ensued, and energy prices shot sky-high (at least by 1970s standards, if not by today's). Even after the embargo ended, energy prices remained high, adding to inflation and rising unemployment.

Federal budget deficits grew, foreign competition intensified, and the stock market sagged. Productivity growth was pitiful, if not negative. Interest rates remained high, with the prime rate hitting 20 percent in January 1981. (Newspaper columnist Art Buchwald quipped that 1980 would go down as the year when it was cheaper to borrow money from the Mafia than from your local bank.)

In desperation, President Jimmy Carter tried to combat the persistent economic weakness and unemployment by increasing government spending while also establishing voluntary wage-and-price guidelines to control inflation. Both efforts were largely unsuccessful.

A sea change in economic theory arrived with President Ronald Reagan's 1980 election. His fiscal agenda centered on his belief that the federal government had become too big and intrusive. In 1981, he introduced "Reaganomics," which was based on supply-side economic theory. His plan advocated reducing tax rates so people could keep more of what they earned, thus inducing them to work harder and longer, which would lead to more savings and investment, resulting in more production. That, in turn, would lead to higher reinvestment in business, which would lead to new job opportunities and higher wages—stimulating overall economic growth.

Reagan cut marginal federal income tax rates by 25 percent, and while he was at it, also slowed the growth in funding for social programs and reduced or eliminated government regulations affecting the consumer, the workplace, and the environment. Fearing that the United States had neglected its military in the wake of the highly unpopular Vietnam War, Reagan also successfully pushed for big increases in defense spending. The budget deficit ballooned, the Fed further cut the money supply, and the economy continued to wallow in recession. U.S. trade deficits, coming off seven bad years in the 1970s, swelled to even bigger negativity in the 1980s, and rapidly expanding economies in Asia—Japan in particular—challenged America for economic power.

Focus on the economy eased in Reagan's second term as he and his successor, George H. W. Bush, presided over the fall of the Berlin Wall, the disintegration of the Soviet Union, and the collapse of communist regimes across Eastern Europe. The focus also shifted somewhat on Wall Street, where "corporate raiders" made mergers and acquisitions (M&A) an art form, buying companies with depressed stock prices and then either restructuring them or dismantling them piece by piece.

Although President Bill Clinton brought Democratic ideology back to the White House in 1993, he took a cue from Reagan, declared that the era of "big government" was over, and reduced the size of the federal workforce. After a brief initial slump in 1993–1994, the economy once again got healthier and people once again got wealthier, in part thanks to greatly expanded trade opportunities after the fall of the Iron Curtain. Technological developments brought a wide range of sophisticated new electronic products. Innovations in telecommunications and computer networking spawned vast hardware, software, and Internet enterprises, precipitating the eventual "dot-com bubble," but also revolutionizing forever the way many industries operate.

The economy—and corporate earnings—rose rapidly. The U.S. economy grew more closely intertwined with the global economy than ever before and Clinton, like his predecessors, continued to push for the elimination of trade barriers. U.S. GDP in 1998 exceeded $8.62 trillion and accounted for more than 25 percent of the world's economic output.

Entering the twenty-first century, the U.S. economy was bigger than ever. Prices remained stable, unemployment dropped to historically low levels, Washington posted a budget surplus, and the stock market gained by leaps and bounds.

Everyone, it seemed, had it made—*but the worst was yet to come.*