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LAWRENCE KUDLOW: THE INTERVIEW

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In a 1998 front-page story, "From Addiction Back to Influence in Tax Cut Fray," the Washington Post reported that Larry Kudlow, "the reigning optimist on Wall Street," was forecasting budget surpluses "hundreds of billions beyond those predicted" by government officials and consensus-minded economists. His many detractors considered his forecast to be "wishful thinking," in defiance of "mainstream economic models."

But Kudlow--today the chief investment strategist and senior managing director of ING Barings--was right, just as he had been right in predicting the Dow at 10,000 five years before it happened, and in calling the timing of the 1990-1991 recession and its subsequent recovery.

Born in 1947, Kudlow grew up in New Jersey and studied politics and economics at the Woodrow Wilson School at Princeton, but cheerfully points out that he is burdened with no advanced degrees. When it comes to financial markets he regards himself as selftaught. He has worked at the New York Federal Reserve Bank, and at the Office of Management and Budget under Reagan.

In 1994, the New York Times published a full-page article, "A Wall Street Star's Agonizing Confession," about Kudlow's life and addiction to cocaine. He resigned from his $1 million a year job at Bear Stearns after missing a speaking engagement with some of the firm's best clients. In 1995 he entered a drug and alcohol treatment program in Minnesota, and two years later converted to Catholicism. Recently, he has been on the Bush-Cheney transition advisory committee.

In our interview, Kudlow talks about his experiences, economic prospects for the new administration, the economic indicators that get his attention, his forecasts for 2010, and his faith.

The American Spectator: What do you think of George W. Bush?

Lawrence Kudlow: You know, to meet him is reassuring. He's fascinating, because he's real smart, and yet he doesn't have to prove it to you.

TAS: Who does that remind us of?

Kudlow: Right. Reagan. Marty Anderson [assistant for domestic affairs in the Reagan Administration] told me there was a bit of Reagan in George W. I was still in my anti-Papa Bush mode, thinking one Bush was enough for any country. But W. wound up with the best of the

Bush character and family values--which Papa Bush always had--without the squishy policy thinking. And I think I know why.

TAS: Why?

Kudlow: One of the things I learned from my own crash and burn is it's good to fail. You learn a lot when you fail. I don't think his father ever suffered. Losing an election is not suffering. It's not a real loss like losing your job, or your wife, or your money. Papa Bush had pretty smooth going, but W. had two big setbacks. He lost his business and was ashamed for years about that. He basically lost his shirt as oil prices collapsed in the 1980s. And from his bittersweet experiences in the Texas oil patch, I think he developed more of an entrepreneurial outlook.

TAS: The other setback?

Kudlow: His business failure was one of the reasons he drank so much. And then he came within an inch of losing his wife. Laura said, you know, "It's either me or the bottle." She basically was out of there. I am impressed with W.'s fortitude. The fashionable world is against him but he hangs tough. He goes to Washington after the election and he has a series of tension-filled photo-ops. Very clumsy looking. You can see it in the body language. He had to sit there with Clinton, sit there with Gore. But he steadfastly talked about two things. Lower tax rates and the slowdown of the economy, and the need for religious faith. He is showing Reagan-esque discipline.

TAS: Staying on message.

Kudlow: If Bush keeps this up he will gain the country's support. Most people in this country work in a business, and most are small businesses. They know there are really only two or three important things. So when they see a president who hammers away at two or three things, they like him. It reminds them of their own life.

TAS: You know him a bit, don't you?

Kudlow: We were roommates for a few days in the mid-'80s. It was a golf outing at Pebble Beach, organized by Steve Dart, Justin Dart's son. I am not a bosom buddy, but you do get acquainted that way. But the last time we had spoken before the campaign was in 1992. He was furious at me, because I was criticizing his father on the air. He called and just reamed me out. I said, "Bushy, I'm sorry. You fire Nick Brady, Dick Darman, and Mike Boskin and I will support you. If you don't, the second term will be worse than the first. I am not for Clinton, but I am not for your dad." When I saw him seven years later, it was clear that he was going to stay tough. And he has. My basic political rule is tax cuts and pro-life. If someone stays sound on those issues, as he has, you can trust the rest will more than likely fall into place.

TAS: What about his advisers?

Kudlow: Some are going to be better than we think. Others I am less sure about.

TAS: Like?

Kudlow: Well, Marty Feldstein and Mike Boskin. They get involved in arguments about surpluses and deficits, government saving and paying down the debt: trying to "Japan-ize" the United States. The Japanese for years were obsessed with saving. They had the highest savings rate in the world, and now they have the lowest growth rate in the world.

TAS: What about Paul O'Neill at Treasury?

Kudlow: My first choice would have been Arthur Laffer, either for CEA [Council of Economic Advisers] chair or treasury secretary. He is a giant figure in economics. I might have said Robert Mundell but he is older and winding down. I thought Wayne Angell would have been excellent because of his understanding of tax-rate incentives and hard money. But O'Neill is an interesting guy even though a lot of people are writing him off as a Jerry Ford, root-canal budget-balancer.

TAS: He was in the Office of Management and Budget under Ford.

Kudlow: He was a deputy OMB director.

TAS: He probably wore his WIN button [Whip Inflation Now].

Kudlow: He probably wore his WIN button. The Ford people had few good economic ideas. They were not as bad as the Nixon Administration. On economics, Nixon was the second-worst twentieth century president. Hoover beats him. But O'Neill was only a deputy OMB director. Some supply-siders are not thrilled because he has never been part of our group. But I've known him for twenty years. He's more of a tax reformer than people think, and he's smart. True, he wanted to raise energy taxes ten years ago. But that was another time. He's not inherently high-tax. He has written and spoken for years about the need for tax reform.

TAS: So you believe a Ford OMB guy is going to lead a supply-side crusade.

Kudlow: I don't know if it's fair to call O'Neill a Ford guy, but most of them are more free-market oriented today than they were 25 years ago. They've changed because they've seen how it can work. I think it's true for Cheney, true for Rumsfeld, true for O'Neill. They are, pardon the phrase, more conservative now. Although you know the Laffer Curve was launched in the Ford White House.

TAS: I thought it was launched on a cocktail napkin.

Kudlow: Yeah, but it was a Ford Administration cocktail napkin. Arthur Laffer was in Rumsfeld's office with Cheney in 1975. Laffer was a paid consultant. At cocktails, he drew the curve for them to explain how dropping tax rates from the prohibitive range would expand revenues. They couldn't convince Alan Greenspan, who was chairman of the Council, or Bill Simon, who was treasury secretary. So Ford never went with it. He had a tax rebate instead, an anti-recessionary "stimulus" like Jimmy Carter's. It lasted two quarters, pumped up the economy and evaporated. The economy sagged right down again.

TAS: Still, the leading salesman of the tax cut is going to be a major old-economy Fortune 500 CEO...

Kudlow: Although he was on the board of Lucent.

TAS: Like I said, old economy. But why are tax cuts still controversial? After Reagan's tax cuts, revenues rose as predicted, national wealth soared, and in the long run we dissolved the deficit, though there was never any serious spending restraint, except later in defense. Yet in the last election, the Republican had a supply-side program and wouldn't admit it. Bush's argument was always: "We are giving you back the money you deserve." Positioning it as a payday for the rich dissolved the moral argument, left the growth issue untouched. And we leave unchallenged the absurd notion that Bush's tax cut is going to cost $1.6 trillion. What happened to the rising tide that lifts all boats? How could supply-siders be so right and yet surrender the war of ideas? Larry Lindsey, Bush's chief economic adviser--what happened to him? He literally wrote the book on the success of the Reagan tax cuts.

Kudlow: I think Larry Lindsey is a good man. But when he was nominated for Fed governor, his nomination was held up for many months by George Mitchell and the Senate Democrats. They bitterly hated his book The Growth Experiment, a masterly defense of Reaganomics. I think he was seared by that experience, and he has become more cautious in marketing a pure supply-side tax-cut model. I don't believe he has lost his compass. Knowing that he had to deal with the Washington press corps, he made a decision to play down some of the rhetoric.

TAS: Supply-side arguments weren't heard at all.

Kudlow: Well, Bush's staff would not challenge the myth that Clinton's tax hike created the surplus. But I am not as hard on Bush as you. He made this case from time to time during the campaign, including a valuable interview he gave to CNBC when he absolutely defended supply-side economics and growth. I grant you that in the public forums he shied away from it.

TAS: The question remains, how did supply-siders win such a great victory in the 1980s, both theoretically and empirically, and yet a Republican president now has to deny it to gain "credibility," and a Republican Congress remains committed to "static analysis"--the theory that tax cuts are a dead revenue loss with no behavior change or growth effect?

Kudlow: Well, one big mistake had consequences for years. We missed a chance in 1995, after we took Congress, to appoint a supply-side director of the Congressional Budget Office. John Kasich and Pete Domenici blew it. Domenici never was a friend of the supply-side. Kasich was on again, off again. We missed that opportunity. They put in June O'Neill, a perfectly nice lady who was utterly baffled by supply-side theory. I remember in September 1998, I spoke to the CBO board, along with some other economists, and I gave a whole rap about capital gains. The 1997 reduction in the capital gains tax rate was already throwing off increased revenues. Even more important was the productivity revolution that was coming from technology investment. Yet the CBO was still predicting 2.5 percent yearly growth, subnormal productivity, and excessively high deficits.

TAS: So we "couldn't afford" tax cuts.

Kudlow: I told them there was this phenomenal wave of entrepreneurship and technological innovation. "The economy is going to grow at 4 or 5 percent for the next several years. That is going to give you a budget surplus next year, and bigger surpluses after that." I hauled out one of my charts, showing $500 billion budget surpluses by the late 1990s. O'Neill thought I was nuts.

TAS: Was anyone else predicting surpluses?

Kudlow: No. In this group of 20 academic economists, I got no support. I was not surprised that Bob Gordon of Northwestern didn't support me. Nor that William Nordhaus of Yale attacked me. I expected to get no support from Rudy Penner, an allegedly Republican economist who always sides with the establishment. But I was surprised to get no support from Republicans like Martin Feldstein of Harvard and John Taylor of Stanford, people who had worked for Reagan and Papa Bush.

TAS: So they missed the growth story.

Kudlow: Right. I got into a rather testy debate with June O'Neill, because I pointed out that the CBO was grossly underestimating tax revenues. "The system pushes people up the slope of a progressive tax code," I said. "It's obvious revenue will grow faster than personal income." She got very testy. Recently, CBO raised its baseline to 3.3 percent growth. So that's progress. It's still lower than the post-World War II historical rates, but it's better than they had.

TAS: How much does half a point matter?

Kudlow: Moving to 3.3 percent annual growth estimate is going to add another trillion or so to the surplus estimates for the next five years. [This has since happened--TAS] And that's not even counting the effect of improved supply-side incentives from a tax cut. At 3.3 percent they are just coming to grips with the historical reality that this country creates more growth than people say. All of those academics on the CBO board assume the horrible 1970s are the baseline. They also think we dodged a bullet in the 1980s. In their view, we had all this crazy tax cutting, Reagan almost destroyed the economy, but somehow the country managed to come through it thanks finally to Clinton and Papa Bush raising taxes.

TAS: So what really happened?

Kudlow: The truth is the opposite. The economy didn't grow worth a shake in the early '90s. Two tax hikes in 1990 and '93 kept growth down to barely three percent. Coming out of a recession, that is nothing. We should be seeing 5 or 6 percent growth early in a recovery. The economy did start growing after the Republicans took Congress in 1994, because that put an end to the threat of more tax hikes and over-regulation. Then in 1996 and '97, we had some supply-side legislation.

TAS: From Clinton?

Kudlow: He became an inadvertent supply-sider. We had a capital gains rate reduction in 1997, from 28 percent back to 20. We also passed welfare reform. This was crucial because it reduced disincentives to work. It was like a tax cut for welfare recipients. We talk so much about reducing the welfare rolls we almost forget we are increasing the work rolls. We also expanded IRA Super Saver accounts, which has capital formation effects. Those are major items; Reagan would have supported them. All of a sudden you see the animal spirits of the economy revive. You could see the numbers literally jumping off the page after 1996. Suddenly the 2 percent and 3 percent quarters become four, five, six percent. Inflation declined--registering less than two percent. And given the poor way those indexes are constructed, that means zero. Maybe even deflation. So the resurgent Phillips Curvers at the Fed, whom Greenspan had joined by then, were proved wrong once again.

TAS: But now the Phillips Curve--this strange idea that economic growth above a certain level causes inflation--is back, along with the even more bizarre idea that to save the economy we have to destroy it.

Kudlow: Craig Roberts says the Phillips Curve survives because it affords planners a role in the political economy. They need a rationale for control. Since all the other manifestations of socialism have failed they are left with fine-tuning growth, as if they could. It's the last vestige of Keynesianism, although I'm not sure Keynes would have agreed with it. The great disappointment is that Greenspan signed on.

TAS: What happened to him?

Kudlow: He will tell you that he believes in a short-run Phillips Curve. In the short run, there is a trade-off between low unemployment and an "overheated economy." In fact, growth is the solution to inflation, not the cause of it.

TAS: Could you expand on that?

Kudlow: Show me a period of high growth, and I'll show you a period of low inflation. Inflation is caused by too many dollars chasing too few goods. More growth and more goods will absorb more money. During the heyday of the Reagan period, growth was almost five percent and inflation dropped to two percent. Under Bush and Clinton I, those numbers reversed. Growth solves a lot of problems, including inflation. And growth is principally a function of incentives, the after-tax return on investment, work, and especially entrepreneurship. So you have two separate levers. If it's inflation you're worried about, use the monetary lever. If it's growth, watch your incentives. If you want less inflation, take liquidity out of the economy through open market operations. That is, reduce the money supply. But boosting growth through improved incentives--tax cuts--will also help. The Phillips Curvers think of tax cuts as increasing the supply of money and thus consider them inflationary. But tax cuts that boost incentives and productivity increase the demand for money and actually restrain inflation.

TAS: Wasn't Greenspan an Ayn Rand fan? He should grasp incentives.

Kudlow: Yes, but he always had a conservative Keynesian streak, so he accepts the limits to growth idea. This is why he can believe the economy gets "overheated" and inflation looms, even when every price indicator indicates the dollar is sound. He believes in bubbles: Too much wealth creation will spur too much spending and economic activity, and that will spur inflation. He absolutely believes that. One of the reasons Greenspan has been easing up on rates is because the NASDAQ has corrected over 40 percent. That was in Bob Woodward's book. I underlined it. "Once the bubble bursts, the stock market bubble comes down by 40 percent, then we're okay." And he did it. What a way to run an economy.

TAS: But you yourself are an inflation hawk. You point out that the collapse of inflation was the biggest tax cut in the 1990s.

Kudlow: Right. James Baker undermined the dollar in 1987, and then Nick Brady and Lloyd Bentsen followed suit. But the Federal Reserve promoted a good monetary policy for most of the 1990s. Reviving the dollar was in my opinion the unheralded achievement of the Clinton Administration. The basic tenet of supply-side thinking is that working and taking risks has to pay. Crucially, it has to pay after tax, adjusted for inflation. So cutting taxes and reducing inflation are not contradictory as the Phillips Curvers think, but complementary.

TAS: This begins to make sense of the economy from the late '80s to the mid-'90s.

Kudlow: What you had in Reagan's first term was lower tax rates and a strong dollar. That was the purest manifestation of what used to be called the "classical model." And the economy responded brilliantly. In Reagan's second term, that started to break down. Probably most decisive, politically, was Reagan's decision to put James Baker, a great chief of staff, into the Treasury Department, and take Donald Regan, a good Treasury secretary, and put him in the White House. He turned out to be a bad White House chief of staff, and Baker was a bad Treasury secretary.

TAS: What did Baker do at Treasury?

Kudlow: First, the tax reform of 1986. He made a deal with Dan Rostenkowski to use static analysis on the bill. In order to "pay for" cutting the top rate from 50 to 28 percent they raised the capital gains tax from 20 to 30. Raising capital gains was a big mistake, because the stock market was valued on the lower rate. It was built into a number of investment decisions, as were valuations of assets owned by banks and savings and loans. Then Baker got into a spider web of negotiations with Germany and Japan over the trade deficit. He agreed that the dollar was too high, and he ensnared Fed Chairman Paul Volcker, up for re-appointment in 1987, into pursuing a loose monetary policy. They killed the dollar. The gold price went up from about $300 to $500 an ounce.

TAS: What was the effect of all that?

Kudlow: The stock market broke down in 1987. And the economy sputtered. Then bad tax and regulatory policy brought on the savings and loan crisis. It wasn't until Greenspan and [Treasury Secretary] Robert Rubin resurrected the strong dollar in 1995 that the Reagan model was resumed.

TAS: So the real story of the 20-year boom is Reagan's giving us what Bob Bartley called the "seven fat years," followed by seven years of Bush-Clinton drift, then a resurgence of incentives and growth in Clinton's second term.

Kudlow: Right. From about '88 to '95, the U.S. economy slowed to less than three percent growth, having been almost five percent during the fat years.

TAS: In 1986 it seemed the rise in the capital gains rate would be a small price to pay for that big income-tax rate cut.

Kudlow: No, because they weakened the dollar and inflation came back. The statutory capital gains rate can be dwarfed by inflation. The inflation rate fell from about 12 percent in 1980 to 2 percent in 1986. That was a major economy-wide tax cut. At a 12 percent inflation rate, a 45 percent capital gains rate, which is where we were before 1978, is effectively a tax rate of over 200 percent. By getting the inflation rate down and cutting the capital gains tax rate, under Reagan we reduced the real effective capital gains tax rate to about 35 percent. Down from 200 percent. That's a huge increase in the incentives on investment. That's when the first big wave of high-tech investment came, and the power of that is still with us. But that investment boom only made sense with a high rate of return, after taxes. In the late '80s, when we devalued the dollar, the effective marginal tax rate on capital zoomed up again and the economy slowed and the rate of advance of the stock market slowed a lot. Remember the Reagan stock market advanced more rapidly in percentage terms than the Clinton stock market, especially during Clinton I. Under Reagan, from a base of about 800, the Dow went up to around 2600, 2700. But after 1986 the market, which I believe is the best economic barometer, meanders. It drifts really from the summer of 1987 to say 1995. If I'm not mistaken, by election day in 1994, it was 3,800, a relatively tiny increase over eight years compared to Reagan.

TAS: Even that drift up was driven by buybacks, companies repurchasing their own shares. And tax-free institutions making mostly conservative investments.

Kudlow: Right. Another measure of this meandering period is that value stocks out-performed growth stocks. Periods of relatively sluggish growth move investors toward a more defensive position. They would rather buy Gillette, Coca-Cola, and Philip Morris than Microsoft or Intel, much less the risky tech companies. Growth stocks don't start beating value stocks until 1995, '96. Then they just kick ass for the next five years.

TAS: That's where the new revenues came from. Growth companies balanced the budget.

Kudlow: Totally. The expansion of these growth companies was phenomenal. These guys were building sales revenues, you know, 35, 40, 50 percent a year, and their capital gains were just unbelievable.

TAS: Who was behind the supply-side revival in Clinton's second term?

Kudlow: It's a very strange story. No one in the Clinton Administration talked in supply-side terms, but they did two very important things. Rubin and Greenspan worked for a stronger dollar, which neutralized the 1993 income tax hike by bringing inflation down. It effectively reduced the capital gains tax rate and restored the incentives to invest. Second, the statutory capital gains tax rate was also reduced, though not until 1997.

TAS: Saying Rubin and Greenspan "neutralized" the Clinton tax hike is a huge claim. Because supply-siders' biggest problem is that people see that the economy boomed under Clinton, who they know raised taxes.

Kudlow: Right, except that after the tax hike, the administration and the CBO were still predicting $200 billion deficits as far as the eye could see.

TAS: But can you support this incredibly important claim that the reduction of inflation actually "neutralized" the Clinton income tax rate increase?

Kudlow: Sure. Clinton raised the top income tax rate from 31 to 40 percent. But even with capital gains tax at 28 percent, where it was raised to in 1986, the reduction in inflation, from 5.4 percent in 1990 to essentially zero in recent years, increased the return on investment far more than the increase in income tax reduced wage and salary incentives. In a period of entrepreneurial creativity, the return on capital becomes more important than ordinary income.

TAS: And income flees massively toward various permutations of capital gains, like options.

Kudlow: That's exactly right. The options revolution in compensation was a largely successful attempt to avoid the statutory tax increase. And then, almost miraculously, came the lower statutory capital gains tax rate. So two important pillars of supply-side thinking were re-instituted under Clinton. Suddenly he was governing as a Reaganite. My take on the success of the 1990s is that between the night Newt Gingrich took the House of Representatives and the night the Monica Lewinsky scandal surfaced, Clinton governed as a supply-side Republican, and the economic results show. After Monica, Clinton moved left to secure his base. He became a big regulator for his last 18 months. And Al Gore ran as a business-bashing, left-wing populist, departing from Clintonomics. Gore should have won by eight points. It's an incredible story. The Democratic Party was on the verge of an historic policy realignment, but they frittered it away. Clinton was the most pro-growth Democrat since John F. Kennedy.
TAS: Well, Kennedy did it willingly. Clinton faced a Republican Congress. He started by raising taxes and trying to nationalize medicine.
Kudlow: But to his credit, he brought in the strong dollar.
TAS: But he appointed a Fed board that eventually undermined Greenspan.
Kudlow: Still, Clinton's shift is the mark of a talented politician. Clinton beat Bob Dole from the right, and he boosted the Dow about 6,000 points. The supply model was resuscitated by happenstance. Newt Gingrich didn't do it. The Contract with America didn't have lower tax rates. It had tax credits and balanced budgets. But it never had a growth component. tas: It was a focus-group document. Typical Gingrich. kudlow: One night, right before they announced the Contract, Steve Forbes, the Wall Street Journal's Bob Bartley, and I had a knock-down drag-out with Gingrich. That's the only time I have ever heard Bartley raise his voice. Newt said, "I hear you have a problem with our tax plan." Bob looked at me and said, "Go ahead, shoot down this thing." And I did. Gingrich got very angry. "How dare you lecture me on tax policy?" I said, "I'm not lecturing you. I'm giving you advice." Then Bartley raised hell. I'd never seen him like that before. In the early '80s, we always had trouble with Gingrich. He was not a supply-sider and was never reliable on economic policy.
TAS: Gingrich was the single most disappointing politician of recent times.
Kudlow: He was a guy with an ego, but not a real policy vision. In the early 1980s, he rode [Jack] Kemp's coattails when he saw how popular Kemp's ideas had become. When Reagan won there were times when we at OMB sat down with Gingrich, and it was hard to know what his position was. You knew where Jack was. He was arguing with Dave Stockman, who had already jumped ship on us. But you didn't know where Newt was. He had his finger in the wind.

TAS: As we speak, the Fed has finally cut rates, a full point this month. [January--TAS] Far enough?

Kudlow: No. The Federal Funds rate should go to four and a half percent. Maybe four. Long-term interest rates have fallen. And we are seeing recession-like numbers--three straight declines of industrial production. But if the Fed gets its interest rate cuts finished, say by March, and in April tax rates are cut and made retroactive to January 1, Bush could be looking like a genius. He may be the guy with the best analytic handle on this.

TAS: He's had good luck.

Kudlow: He sure has. Economy declining and surplus rising! Better to be lucky than smart, they say. Better still to be lucky and smart.

TAS: We're all down on Greenspan these days. But you spent years promoting him for canonization.

Kudlow: Absolutely. I wanted sainthood. "He deserves a Nobel Prize," I said on the air. I said it because he acknowledged the impact of the new technology--that there was no need for the Fed to tighten automatically with four percent growth. He conceded that enhanced productivity was raising the "speed limits" of the economy.

TAS: Right.

Kudlow: Now, that wasn't exactly what I wanted to hear, because I don't believe "speed limits" are appropriate at all. Still, he was taking on an establishment that said that 2.5 percent is the most we can grow without inflation. So I gave him credit for that. Then, after the spring of 1999, he relapsed into the standard, People's-Republic-of-Cambridge Phillips Curve nonsense. That's all it is. That has been the most regrettable part of his tenure. He had a chance to provide breakthrough leadership that would have lasted beyond his time.

TAS: Do you know why he stumbled?

Kudlow: No, I don't. It was like somebody flipped a switch. The fact that the Fed has 500 Ph.D. economists, the vast majority of them from universities in the northeast, especially the Ivy League, doesn't help. Greenspan started playing down the role of money in inflation, which is the key. And we started getting all this fine-tuning nonsense: unemployment is this, wages are that, retail sales are this. Inflation is a monetary problem. If there is too much money out there, you'll know it. Because the gold price will go up $100, or the bond rate will go up 100 basis points. It has nothing to do with retail sales. But Greenspan obscured all that. His relapse means we have made no progress on the science of central banking.

TAS: Still, compared to previous chairmen, he was almost a miracle worker for years. And with Y2K there was an 18 percent jump in the money supply. Maybe he gave us one rate increase too many. Is that enough for excommunication?

Kudlow: No. But genuflection isn't good either. Greenspan rehabilitated a flawed theory. That destroyed trillions in national wealth, at least temporarily, and will now give us a few tough quarters. Worst of all, he kept alive this notion that growth and prosperity cause inflation. We need to get beyond that. We are fast approaching a time when the information economy can produce as much as six percent growth a year. That level should be the goal of fiscal policy. And it will actually suppress inflation.

TAS: There are two open chairs on the Fed Board, and Roger Ferguson's term expires soon. So Bush has three slots. What should he do? Who on the board should he re-appoint?

Kudlow: No one. The president can't fire board members, sadly. If he could, I would recommend he fire Lawrence Meyer, the principal Phillips Curve theorist on the Fed. He has been unrelenting in his mistakes. As far as I can determine Ferguson has just been a garden-variety Phillips Curve guy. I would not have reappointed Greenspan to a third, sorry, to a fourth term. As a general rule, I don't believe anybody should be appointed to more than two terms for anything. Four is off the charts. You get stale. And they're grinding jobs. Alan is 74 now. I don't mean to denigrate that, but it's a tough job, double-digit work hours every day, and Alan is a hard worker.

TAS: Do you have a replacement in mind?

Kudlow: Robert McTeer. He has been the president of the Dallas Fed for almost ten years. He is a free-market, new-economy, price-rule market watcher. He actually objected several times to Fed policies last year. He would make an excellent Fed chairman. He would also make an excellent Treasury official as perhaps a transition to the Fed. I'd love to see him as Paul O'Neill's deputy.

TAS: But is Greenspan still the best Fed chairman in history?

Kudlow: You know, in his own clumsy way Paul Volcker may be the best Fed chairman in history. He's an odd character--by no means a supply-sider. By and large he didn't like Reagan's tax cuts. But he took the inflation rate from fifteen and brought it down to two, roughly between 1980 and 1986. You have to say that was the most extraordinary achievement in the Fed's history. Alan took the inflation rate from four or five to two. That is a fine achievement, but not quite the same. I was on a panel with Volcker the other day. He's a very eccentric man, very dogmatic. But in his own way, brilliant. Remember, he was around when the dollar was linked to gold. He was in the Treasury Department in the '50s. He's a relic of the past. You know what? He gave us an antiquated monetary policy. And that's what was needed. He took the gold price down from $800 to $300 an ounce.

TAS: You are still largely a gold guy?

Kudlow: Yes. It provides important information about inflation.

TAS: But is gold really relevant, with all of these currencies trading against each other? We have wonderful barometers. Why still gold?

Kudlow: It has not failed me. When gold is low, inflation is low. In 1999 and 2000 when Greenspan was wrongly obsessing over inflation, I just kept saying wake me when gold hits $300. Sure, the gold bugs are gone, the investors. But I don't want gold to be a hot investment. The minute it is, I know the rest of the story is going to fall apart.

TAS: Gold bugs bring bears?

Kudlow: That's where I came in. As a young pup in the 1970s, it was precisely the fervor for gold that taught me how much trouble we were in. Because if you're buying gold, you're not investing in your brother-in-law's new wireless application to get on the Internet, right?

TAS: What about Walt Wriston's Information Standard? This notion that increasingly central banks or governments are not going to be able to misbehave because of the efficiency of price signals on instantaneous global trading networks?

Kudlow: There's a lot to that. The financial markets act as cops and flag bad policies. Global electronic financial markets were the first to embody the information age. They punish countries by withdrawing capital immediately. In that sense, Walt is right. But you still have to have a reference point. And there are few market indicators that will tell you whether you're winning or losing on inflation. One of them is gold. Another has to be interest rates. Particularly long-term rates. If your currency is collapsing, you must be doing something wrong. If your stock market is plunging, you are doing something wrong. Because hundreds of millions of people cannot be wrong. But a handful of Ph.D.s with their computer models can be wrong.

TAS: It has happened.

Kudlow: You're darned right it has. They lack humility. If I have a forecast and market events are proving me wrong, I need the humility to go back and ask myself something I don't want to ask: What did I do wrong? Now we have Greenspan sitting there with a board and 500 Ph.D.s from the best universities, God help us, all of whom, virtually, believe tax cuts will overstimulate the economy. They have no clue how the people who actually drive the economy behave. Nonprofessionals investing in the market have a better grasp of these principles than the experts.

TAS: Why this pessimism of the intelligentsia?

Kudlow: I had this wonderful experience at the Council on Foreign Relations a few months ago, debating Robert Schiller from Yale, the guy who wrote Irrational Exuberance. We're in front of 300 people--enemy territory. He is a total pessimist-- he thinks in ten years the Dow will be 6,000. I believe it will be 35,000. He believes that the U.S. is incapable of growing above 2 or 3 percent. I believe it can grow by five. He believes we're in tulip mania. This sort of pessimism comes from academic culture. People who aren't in the day-to-day commercial, entrepreneurial battle have no confidence in the people of this country. They believe that without the wisdom of the Ivy League, the markets will go haywire. And lacking faith in others, they oppose freedom for others.

TAS: That's why they oppose tax cuts?

Kudlow: Right. It's absolutely predictable that the one thing liberal economists are never for is tax cuts. They never favor moving money out of the government and back to individuals. Their big battle cry now is "Let the Fed take care of recovery." Tax cuts might jeopardize the budget surpluses, bring back inflation, "overheat" the economy. We can't have tax cuts, ever. Paul Krugman, Larry Summers, the New York Times editorial page: all on cue. Having the Fed engineer a recovery is exactly the policy mistake of the '70s. It shows just how retro the economics profession is. They've learned nothing. A warning here. I do believe the Fed should cut rates. But depending on the Fed to lead the economy by pushing out too much money raises the possibility that the Fed could flood the market with reserves for the next 12 months to stimulate the economy. Then by 2002 we'd have inflation of six or seven percent without lower tax rates to increase production and investment. Excess money will drive interest rates up, however big the budget surplus.

TAS: Given the size of world financial markets, how much impact can the U.S. deficit, or debt, have?

Kudlow: You're talking about a fifteen or twenty trillion dollar daily trading day in the world financial markets. A $50 billion buy-back of Treasury Bonds has virtually no meaning. I'll grant you if the Treasury goes out and buys back 30-year bonds, the price will go up that afternoon. You'll see market dislocation for a few days, but it will settle quite quickly.

TAS: Is the center of gravity of American politics shifting?

Kudlow: The center is moving toward free enterprise, ownership, investment. The primacy of markets over governments as organizing and growth tools is accepted. A hundred million Americans are invested in the stock market. Bush can get these tax cuts through because free enterprise is the center in American politics today. That's a major change. Clinton in many ways acknowledged it.

TAS: And it looks like Bush will get his tax cut...

Kudlow: And turn out to be an excellent president. The force is with him. The political culture is with him. That's really the message of this election. Al Gore should have run as a Clinton Republican. It wasn't about his personality. It was about his message.

TAS: So I take it you don't think Bush's tax cut is going to cost us $1.6 trillion over ten years, right?

Kudlow: Of course not, that is absurd. You can only believe that if you believe the 1980s never happened, tax cuts have no effect on the economy, and that even if you pay people more after tax to work, save, and invest they won't do it because they don't care about the money. You have to ignore not only the Clinton boom after 1997, but the fact that personal income tax receipts rose more than a third in the wake of the Reagan tax cuts. Plus decades of global evidence that GDP rises in the wake of tax cuts and falls after tax increases. The truth is--on a strictly back-of-the-envelope basis--tax revenues will probably rise by $300-$500 billion over ten years as a result of Bush's tax cut. A tax cut of these dimensions will boost GDP growth about half a point a year, to about four percent rather than three or three and a half. The growth is cumulative, of course, you know, compound interest, man's best friend. In a decade in which we start with a $10 trillion a year economy, and end with a $15 trillion a year economy that means hundreds of billions of extra revenue. Of course these models going out a decade tend to be nonsense anyway, another reason their $1.6 trillion number is ridiculous. The real point is that if you strengthen incentives to work and invest, the economy will grow, and growth trumps everything. We should target four percent annual growth minimum because that's what we have done except when we have depressed incentive with high taxes and inflation. If you add the effect of new technology on productivity you are looking at five percent. That is where I think this is going. With five percent you're going to see a massive recovery of the NASDAQ. The mix of companies will change. But the bandwidth revolution will come and the Internet will take over economic life. The companies that lead that change will lead the NASDAQ to 10,000.

TAS: In this decade?

Kudlow: By 2010 it should reach 10,000. The Dow Jones--which is really an old-economy value index--should keep rising, because the old dogs are learning new tricks.

TAS: The NASDAQ at 10,000 will please my wife. But what about my mother? Where do you expect the Dow to be at the end of the decade?

Kudlow: I've been on the record for 35,000 for awhile.

TAS: The world has changed.

Kudlow: And it is not going back. That's not the way history works. Voters in free countries will keep driving their politicians toward a prosperity model. You're seeing it in Germany, England, Italy, South America. Once you get a taste you want more. They're getting a taste of freedom in China. They'll never go back. We're unwinding the -isms of the twentieth century, which blocked progress in major parts of the world. Fascism, communism, socialism: it's all unraveling. Through much pain in the twentieth century, we have learned what works. The human expense was staggering. But we learned and history will keep pushing us in the right direction.

TAS: Can we talk about some personal things? You may be the only Wall Street economist who ends his commentaries with a call to faith. How did you become a Catholic?

Kudlow: I had a problem with alcohol and cocaine. In the winter of 1993 I had spent a month in a treatment center here in New York. It taught the twelve-step program. God plays a role, but it's more the spiritual God of your choice. But at least there's something. I was not raised religious but I was searching for help. I remember that in this little prep school that I went to, the Dwight Englewood School in New Jersey, we had to say the Lord's Prayer in homeroom. Every morning at your desk you put your head down and say the Lord's Prayer. I was there grade seven through twelve, so it's something you remember. When I was going into this dark abyss with alcohol and cocaine, after some terrible binge, I can remember lying in bed desperate and I started saying the Lord's Prayer. What made me do that? Just--I was desperate, I was trying to ask for help. You know, who was going to get me out of this? I started searching for God.

TAS: So then what happened?

Kudlow: It was Jeff Bell, an old supply-side ally, who actually got me started with the Church. That same winter I was in the treatment center I bumped into Jeff on the street. I was still at Bear Stearns so it was 45th and Park. Now I knew that somewhere along the line he had converted to Catholicism. We started talking, and I told him--I don't know why because not many people knew about my problem yet--I told him that I was taking some steps that had recreated my faith in God. I didn't really tell him much. Then one day Father C. John McCloskey appeared at Bear Stearns. My secretary said, "This priest is here to see you." No appointment, but a lot of the partners donated to various charities. So I was ready to pull out my checkbook and write a thousand dollars to whatever. But this guy didn't want any money. He was a friend of Jeff Bell's and he wanted to talk to me. And he was a very engaging man.

TAS: Wasn't he a gold trader before becoming a priest?

Kudlow: Right. At Merrill. But that day he said he had been watching me on TV on the financial shows. "You've changed," he said. He was right. I was trying to be more restrained, calmer, things they taught me in treatment. So then he asked me, "Do you believe in the hereafter?" My answer was yes, because that's what you're taught in the Jewish faith, though I had not been raised very religious and I hadn't been in a temple since I was fifteen. Then, "Do you believe in Jesus Christ?" And I said I didn't know. But I didn't say no. He gave me a book or two to read and then said: "Why don't you try going to Mass?" I told him I had never been. "Do you have any opposition to it?" I said no. But, I would feel a little odd just walking into a Catholic Church. He said, well, lots of people do it. Then he introduced me to a friend who went to St. Thomas More on 89th and Madison, near where I lived. And I loved it. I loved the Mass.

TAS: Why?

Kudlow: If done right it has a certain mystical quality, and it appealed to me. It was different from anything I had been exposed to. I went to a retreat and I didn't like it because I didn't understand it, mostly. But it wasn't church. The church part is what I liked, the actual Mass. I liked the robes, the smoke. I loved it. All these rituals and rules. I began to realize that for the past eight or ten years I had been living without them. I was the rule. I was so self-centered. I'd just do whatever I felt like. I was in my master-of-the-universe period. You can't live that way. Nobody can. I knew it wasn't good and the drugs and the booze were part of it.

TAS: How are drugs part of that?

Kudlow: You become so self-centered and self-willed that you decide you can do anything, without regard for others. I wasn't showing up for events, for friends, for my wife. I'd go missing in action for days. I've made amends to people directly, but still, I'm ashamed about that period. But the church offered me a regulated regime for life, as did my twelve-step program. The two are similar because Bill Wilson, the founder of A.A., had been part of the Oxford Group, and a Catholic priest from St. Louis was his mentor. Anyhow, I knew this was something I should be doing, just from a selfish standpoint. I needed regulation. I needed to be taught rules of the road. It took me awhile to get my arms around it. But as I hit bottom, Ilost jobs, lost all income, lost friends, and very nearly lost my wife. I was willing to surrender and take it on faith that I had to change my life.

TAS: But you became a Catholic. So you had to stand up and say I believe some very specific things.

Kudlow: I was going to Mass on Sundays. And we recite the Nicene Creed, the church's statement of beliefs. There came this one day when I stopped just mouthing it and read it in an intellectual, cognitive way, and realized there's a whole story here. If you read the eucharistic part of the Mass, there's a whole story there and it's a fabulous story.

TAS: What is that?

Kudlow: It's--we are partaking of the body and blood of Christ. That's what I understand the Eucharist to be. We are pledging our faith in him and what he taught and all of a sudden it clicked, that Jesus Christ does not want me to touch alcohol or drugs because I wreck my body and I wreck his body and I wreck my life. Jesus died for me, too. And that is my redemption. I'm not a Catholic intellectual. I will never be one. I'm not interested in that. I'm interested in how I live my life each day. How I conduct my relationships with people. My view of Lord Jesus is very basic in that sense, though I have read some books that are interesting to me, including Fr. Richard John Neuhaus's recent book, Death on a Friday Afternoon.
TAS: He's a priest in New York, edits First Things.
Kudlow: The basic thought in the book is that even we optimistic Americans mustn't ever forget that Jesus spent that time on the cross, painfully. His crown of thorns was sticking into his skull, he was nailed to the cross, and it was horrible. The book had an impact on me, because in my own mundane, low-level way, I was on the cross. I don't know if I've had salvation, but I have had a change. Sobriety is one of the keys to my faith. And that's good because for me to destroy my life is a rejection of Jesus. In my worst moments--and I still get a few--the reason I don't go out and do something crazy is because I don't want to break my bond with God.
TAS: Sometimes people forget how tough addictions can be.
Kudlow: You see, what this journey is really about is changing along Christian principles. I still do stupid things, but I also go to confession. One of the things I like about Mass is that you go on your knees for part of the time. It is a wonderful thing to learn some humility. I was at Mass the other day and I was having some trouble, and I prayed. I didn't ask for an outcome, just help. Please show me some clarity, some calmness, give me a sign, and it worked. Took about a day, but it worked. I don't pray for stuff that I want. I ask help for stuff that I believe I need.
TAS: The Pope would say that the original reason God gave us liberty was to complete his creation. And that does take us back to economics and politics. It's no accident that your favorite dead economist, Joseph Schumpeter, focused on creativity.
Kudlow: That's why "supply side" doesn't really capture it. The reason we have the best economic and stock market record in the world is we are the freest country in the world. We call it supply-side economics, but what we're really fighting for is more freedom. Not unlimited freedom, and that's where faith comes in. Since God granted us our liberty, for which we are eternally grateful, we must reflect that by abiding by his rules. It's the rule part that I've come to acknowledge and frankly love. This is part of that mystery of faith, but I believe Jesus is with me. He enters my body and mind as long as I'm open to him and prevents me from doing something really stupid or from misbehaving. I believe that. Last Saturday, when I was at sixes and sevens in

my own head, which is a risky real-estate section to be in, I believe Jesus came to me. I believe he somehow entered into my head for the next 48 hours and helped me get through this little patch. People brought Jesus to me: Fr. McCloskey, Jeff Bell, my mentor Sim Johnston. And He helps keep me sober every day and helps me to discharge my responsibilities.

TAS: Do you think you will write more about this?

Kudlow: I believe it is possible that the Holy Spirit can bring a certain ability to explain my faith. But not in an intellectual way. I don't possess those tools. Just in a personal way: Here's why I go to Mass, here's what it's done for me. Some people want me to carry the sword of Catholicism the way I carry the sword of free-market economics. It's not my goal and if it does happen, it will not be by my design. It's very personal. Jesus is my Father. He's also my Supreme Court because the court has rules and if you break them you get into trouble. In my twelve-step program there's all these young kids who went to Catholic school and rebelled. And they always get up and say how they rebelled against the Church and its rules. I just nod my head and kid them. I say, well, you don't understand how wonderful those rules are. Take it from me. I came to it late in life, but that's exactly the way it was supposed to be. I wrecked my life. It was literally destroyed. My old life was taken and a new life has been born. I understand now that all that had to happen. There's a script here. It's just that I didn't write it.

-- The American Spectator, March 2001