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Where has all the exuberance gone?

By Philip Jefferson

It was all going so well. The economy had expanded for more than 35 consecutive quarters. Inflation was low, and stock prices were high—and growing rapidly. Consumer confidence was high, and unemployment was low. Happiness, it seemed, was only a dot-com away. It was spring in the year 2000, and life, at least as defined by the state of the economy, was good. What has become of those exuberant times? The answer to this question contains keys to understanding today's economy and where it might be headed in the future.

To answer the question, one must consider the challenges facing the economy 18 months ago and the response of policy makers to those challenges. Our story has four actors: households, firms, the Federal Reserve (Alan Greenspan's shop), and the government (both administration and Congress). The challenges then were high (and rising) financial asset prices and rising energy prices. High and rising financial asset prices stimulate the economy by encouraging households to spend in excess of current income. This is the so-called wealth effect. Rising energy prices slow the economy by raising the costs of production. Good policy makers know that if spending outpaces production, then an increase in the rate of inflation will result.

Not too long ago, the economy was flying high. Can fiscal policy and tax breaks turn it on again?

Because they lived through (or at least read about) the 1970s, they also know that rising energy prices can engender rising unemployment and inflation. Early in the year 2000, there was a need for policy action.

But by whom and when? There is really only one answer to this question: the Fed. Because of the delays associated with the design and implementation of fiscal policy, responsibility for short-run macroeconomic stability has fallen on the Fed. Even



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though it can act quickly, it takes 6 to 18 months for a change in interest rates to have an impact on the economy. Inflation was not a clear and present danger when Greenspan and company started raising interest rates in early 2000. Incipient inflationary impulses and possible spending pressures as a result of the difficult-to-

measure wealth effect provided the justification for the final interest rate increases in spring 2000. The conduct of mon-

etary policy requires the gumption to act decisively and with foresight. Unfortunately, the Fed went too far.

The interest-rate increases—and a decrease in the rate at which businesses were willing to augment their stocks of capital equipment and information technology—played an important role in the diminution of exuberance. How exuberant can U.S. households be in the face of a loss in the value of their assets of \$1.43 trillion in the first quarter of 2001? How can firms

continue to invest when profits are 6 percent lower in the first quarter of 2001 relative to the first quarter of 2000? Exuberance has given way to volatility and uncertainty. What is to stop the economy from teetering over the edge into recession?

It's not pleasant when policy mistakes are made in real economies. Real people lose their jobs and their homes. Good policy makers try to correct mistakes once they are realized.

This is one interpretation of the series of interest-rate reductions undertaken by the Fed this year. Other things being equal, they will buoy the economy by encouraging households to continue their normal spending patterns. Also, the terms on which financial firms lend should be relaxed as a result of the interest-rate cuts. This may be of particular help to small firms that depend more heavily on their relationships with banks.

Can fiscal policy help to bring the exuberance back? One would think that the recently passed \$1.3 trillion tax package would have some impact on the current state of the economy and its prospects for the future. By the time you read this essay, it is likely that you will have received a rebate check from the government of between \$300 and \$600. This represents the first segment of a tax package that is spread over 10 years.

What did you do with that rebate? Let me take a guess. You either (1) used it to pay down existing debt; (2) deposited it in your savings account; (3) spent it; or (4) did some combination of 1, 2, and 3.

Economic theory suggests that option (4) is more likely and that the actual fraction of the rebate spent depended upon whether you view the promise of tax relief as being permanent or temporary. If you thought tax relief is temporary, then you were likely to have spent less of it.

My prediction that the tax package will have a small (if any) impact on the current state of the economy is based on the belief that most of you spent only a fraction of the rebate on newly produced goods and services. Fiscal policy alone cannot bring back the exuberant spring of 2000.