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FED SHADOW

The 1990s Boom-and-Bust: Learning the Wrong Lessons

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George Santayana said, "Those who cannot remember the past are condemned to repeat it." Some special hell, then, must await those who *do* remember the past, but who *remember it wrong.*

That is the fate awaiting those inclined to uncritically accept the fable peddled on the front page of Friday's ***Wall Street Journal****.* "Did Greenspan Push His Optimism About the New Economy Too Far?" by **Greg Ip** and **Jacob M. Schlesinger** is an utterly false remembrance of the last half-decade's monetary policy as administered by **Alan Greenspan** and the **Federal Reserve**. But the implications of the piece are probably even more troubling for what it suggests about the received wisdom regarding the Fed's role in the late 1990s boom and subsequent bust. To the extent that this twisted rewriting of the history of the period is enshrined as the accepted mainstream analysis, the risk remains ever-present that the errors will be repeated.

The piece is built on the idea that Greenspan was such a true believer in the tech-driven productivity story, he was able to keep at bay the advocates of conventional nostrums holding that the Fed should regulate the economy's growth rate under preconceived "speed limit" notions. The inference is that in so doing, the Fed chairman helped sow the seeds of an "unsustainable" boom for which we are all now paying the price. "Over the four-year period from 1996 through 1999, Mr. Greenspan persuaded his colleagues, first, not to raise interest rates, and then, when rate increases became inevitable because of inflation fears, to institute them more slowly than many would have wanted."

That is, to put it mildly, a creative rendering of events. Perhaps the *Journal's* research files erased the record of the March 1997 rate hike, which occurred during the span over which Ip and Schlesinger maintain Greenspan had "persuaded his colleagues" not to raise rates. Beyond that, though, the fact is that despite the hand-wringing of **Fed Governor Laurence Meyer** and his fellow Phillips Curve apostles, this period coincided with a steady decline in reported inflation and the collapse of inflation expectations, as opposed to the increases predicted by their antiquated models. Indeed, this reduced risk to the dollar's real purchasing power was a critical underpinning of the capital-rich environment which spawned the innovation-based productivity "revolution."

And the "inflation fears" that made rate increases "inevitable" were hardly forced upon a reluctant Alan Greenspan: the fears were entirely of his own invention and imagining -- and the subject of his own intense advocacy. Only an amnesia victim could fail to recall Greenspan's warnings about the "dwindling pool of available workers" and the "wealth effect." Certainly, it requires no superior powers to recall what may have been Greenspan's most creative rationalization of all – the idea that by encouraging "an imbalance of supply relative to demand," accelerated productivity growth was *itself* an inflation risk factor.

One must conclude from the Ip-Schlesinger narrative that just as the Fed had no real appreciation of the forces coalescing to create the late-90s phenomenon, neither does it have any understanding of the extent to which its own errors loomed large in bringing it to an end. Nowhere does the piece even mention the Fed's boosting of an already high real funds rate by

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175 bps between mid-99 and mid-'00, by which time it was becoming all too clear that risk premia in the cost of capital were rising in anticipation of sharply slower growth. The Fed did not finally acknowledge that reality until the end of last year, up until which time it was still biased to tighten in fear of an outbreak of “wage inflation.”

One should bear in mind that the formulation which holds that the depression in high-tech capital investment is the inevitable consequence of the unbridled and short-sighted enthusiasm of investors, entrepreneurs and businesses for all things "tech," also allows the Fed to avoid answering for its critical role in the collapse. TM