

ON THE FED'S DEMAND BUBBLE

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It should now be clear that the Federal Reserve caused, or at least accommodated, the bubble in aggregate nominal demand from early 1998 through early 2000. Moreover, the Federal Reserve chose to wring out this excess demand by late 2001, and by late 2002 total demand was significantly below trend (Figure 1). The primary open questions are whether the Federal Reserve should have caused or accommodated the bubble and what the Fed should have done once the bubble was in place.

At this point, it is important to distinguish between the bubble in aggregate nominal demand and the nearly synchronous and much larger bubble in equity prices. At the peak of the demand bubble, aggregate nominal demand was only about \$320 billion above trend. The bubble in equity prices, in contrast, was about \$7 trillion. The monetary stimulus that led to the demand bubble may have contributed to financing the equity bubble but was only a small part of that story. Another study would be necessary to estimate the magnitude and timing of the equity bubble if the Federal Reserve had maintained a trend rate of growth of aggregate demand throughout this period. Until such a study is completed, there is no basis for holding the Federal Reserve responsible for the equity bubble.

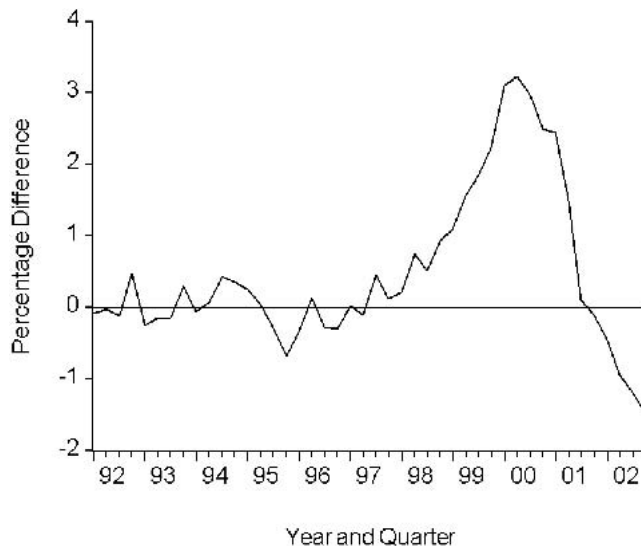
Stable Growth in Demand, 1992–98

I define a demand bubble as a level of demand that is significantly higher than expected. For this analysis, I define aggregate nominal demand as nominal final sales to domestic purchasers—an aggregate equal to nominal GDP minus the change in inventories minus exports

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FIGURE 1
U.S. DEMAND RELATIVE TO TREND: THE FED BUBBLE



plus imports. And I estimate expected demand based on the trend of this variable over some period before the bubble.

For the 25 quarters beginning with the first quarter of 1992 through the first quarter of 1998, this measure of demand increased at a remarkably steady 5.5 percent annual rate, as indicated by the following regression:

$$LD = 3.653 + .0551 \cdot \text{YEAR} + u, \text{ where } LD \text{ is the log of demand.} \\ (.031) (.0003)$$

$$R^2 = .999 \text{ S.E.R.} = .0029$$

The standard deviation of demand from this trend was less than 0.3 of one percent, and demand was always less than 0.7 of one percent from this trend. The Federal Reserve proved remarkably effective in stabilizing the path of demand over a period that included the jobless recovery of 1992, the preemptive attack on inflation in 1994, the Mexican financial crisis in 1995, the Asian financial crisis of 1997, and two presidential elections—despite the fact that it never formally adopted a demand target. *This was probably the most successful period of monetary policy in the history of the Fed.*

Acceleration in Money Growth and Demand, 1998–2000

Beginning in the second quarter of 1998, however, demand increased substantially relative to this trend for the next two years. The reasons why the Federal Reserve increased the rate of money growth beginning in 1997 and allowed a substantial increase in the growth of demand for the next two years are not obvious, but it is plausible to attribute this increase as a response to a succession of financial crises—from the Asian crisis in late 1997 to the collapse of Long Term Financial Management and the Russian default in 1998 to the Brazilian devaluation in early 1999 to the Y2K anxiety at the end of 1999. Whatever the reasons, the effect was to finance a demand bubble. Demand was only 0.2 percent above trend in the first quarter of 1998 but increased to 3.2 percent above trend in the second quarter of 2000.

The important question, to which I have no easy answer, is whether the stability of aggregate demand is more vulnerable to the collapse of a major financial institution or to the unusual monetary stimulus that is often triggered by an attempt to avoid or mitigate the effects of such a collapse. I do know that both the Fed and other political institutions are overwhelmingly motivated by a “Not on My Watch” incentive that limits the probability of a convincing test of whether monetary policy should ignore such financial crises. After hearing that I had opposed the bailout of Continental Illinois when a member of the Council of Economic Advisers, for example, Arthur Burns summoned me to his office at the American Enterprise Institute for a stern lecture that I should never oppose the bailout of a major financial institution; he claimed that the most important decision during his undistinguished tenure as chairman of the Federal Reserve Board was the bailout of Franklin National. The political cost of higher inflation or a demand bubble seem small and deferred compared to being blamed for failing to respond to a major financial crisis. My judgment is that the contagion effect of a financial crisis is much smaller than is perceived by political officials, but I am not sure that I would want to be an official who tests this proposition.

From Stimulus to Overly Restrictive Monetary Policy, 2000–02

Whatever the reasons for the monetary stimulus that led to the bubble, the Fed started to tighten in early 2000, and the demand, inflation, and asset bubbles all peaked in the spring of 2000. At that

point, one option was to try to reestablish a trend rate of increase of demand from the peak, in effect absorbing the demand increase in a one-time increase in the price level. The other option was to wring out the excess demand before reestablishing a trend increase in demand. The Fed apparently chose the latter option, maintaining a tight monetary policy through the end of 2000. This led to a very sharp reduction in the rate of increase of demand. Demand returned to trend by the end of 2001 and by the end of 2002 was more than 1 percent *below* trend. Despite a record reduction of the federal funds rate through 2001, monetary policy was still relatively *tight*, that is, not sufficiently expansive to restore the prior trend rate of growth of demand.

Conclusion

After the fact, one is tempted to conclude that this bubble and the Fed's response to it was the most serious mistake by the Fed in the past 25 years. Such a conclusion, however, implies controversial conclusions to two other questions: one, that the Fed should have maintained a steady growth of domestic demand despite the succession of financial crises from 1997 through 1999; the other, that the Fed should not have tightened as much in 2000 in an attempt to restore a trend growth of demand from the bubble peak rather than from the bubble base. My own judgment is consistent with these two conclusions, but it is not a judgment that I share with much conviction or with many others.