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The Stock Market and Monetary Policy: Comedy or Error?

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What role did the stock market really play in the long business expansion of the 1990s—and in its apparent demise? Or did causation flow the other way? How irrational was the exuberance? Most important, how should the Federal Reserve authorities have played this wild card, theoretically beyond their purview and yet maddeningly astride their path?

These questions will bedevil us for a long time to come. Indeed, after nearly three-quarters of a century, scholars are still trying to make sense out of the tea leaves left by the complex interactions of the business cycle, Federal Reserve policies, and the stock market of the 1920s and 1930s.

A more recent example of such a puzzle exists but enjoys little critical analysis. To the contrary: The degree of agreement about these particular events is unusual in an area where controversy is the norm rather than the exception. I refer to Federal Reserve policy in the inflationary era of the 1970s, which a broad consensus has condemned as too politically oriented, too influenced by the unemployment numbers, and too short-sighted.

Although these accusations are accurate at first glance, they are incomplete. In the 1970s, the Fed had to wrestle with an extraneous factor as powerful in its ramifications as the stock market, but also beyond its direct control and beyond the purview of the standard targets and instruments shaping its daily work. The bugaboo of this period was unemployment, but not the unemployment resulting from the backlash of the business cycle. Demography was the villain of the piece.

The fruits of the baby boom of the first 20 years after World War II generated a mighty and swelling harvest of young job-seekers who flooded the labor markets from the late-1960s onward. While the civilian labor force grew at an average rate of 1.2 million a year in the first half of the 1960s and by 1.7 million in the second half, the growth rate was up to an annual rate of 2.6 million by the second half of the 1980s—after which it tailed off with extraordinary abruptness. Thus, the number of jobholders at the deep cyclical trough in early 1975 may have been 7 million higher than the number of people at work at the 1969 peak, but the labor force had grown by 12 million in the interim and was now pushing the unemployment rate close to 9%.

How would you have voted as a member of the Federal Open Market Committee under conditions like this? As Thomas Mayer, a long-time student and critic of the Fed, has observed, a careful study of the minutes of the Open Market Committee during the 1970s reveals no tendency to time monetary policy to suit the requirements of the politicians.* Rather, the overwhelming blame must rest "on the intellectual environment," in which the Phillips Curve was widely accepted as gospel, and the gargantuan repercussions of the baby boom infected every decision. If the system had not been subjected to a demographic challenge of unprecedented magnitude, the triumph of monetarism might never have come about, nor would the fallacies of the Phillips Curve have been revealed.

The boom in the stock market bears no immediate resemblance to the boom in baby production in the early postwar years, but the family likeness is strong in the context of this discussion. The stock market has been every bit as much a part of "the intellectual environment" as unemployment had been 20 years earlier. With such relentless focus of attention placed on the Dow and the Nasdaq in almost every facet of daily life in the 1990s, how could one expect the Open Market Committee members to have pretended that the stock market had no relevance to their deliberations?

*Mayer, Thomas. *Monetary Policy and the Great Inflation in the United States: The Federal Reserve and the Failure of Macroeconomic Policy, 1965–1979.* Williston, VT: Edward Elgar, 1999.