

The Economy in Perspective

An embarrassment of riches... In the not-too-distant land of Cornucopia, an inventor named Henri Lagnippe found a way to increase the efficiency of power generation by a factor of five. Whether fueled by coal, water, sun, wind, or nuclear material, electrical power could now be produced much less expensively than before. Moreover, genius that he was, Lagnippe showed no sign of letting up. The previous year, he had discovered how to reduce the friction of ball-bearings by one-third; the year before that, he had patented a process to improve the yields of corn and soybeans dramatically. And now he was rumored to be on the verge of finding a foolproof method to protect information traveling on the Internet.

At first, as companies saw a chance to sell more products at a lower cost, they began to extend their work hours and offer more jobs. Cornucopians benefited from greater earnings and the ability to buy products at better prices. Corporate profits soared and businesses began stepping up the pace of capital investment. The entire process repeated itself until economic activity reached fever pitch. Investors raised their notions of the value of Cornucopian businesses, which promised to be more profitable in the future than in the past. These optimistic investors bid up the price of equity shares, and the stock market soared to new heights: Boom times had come to Cornucopia.

If that were the whole story, its ending would be a happy one. But there is more to chronicle. Cornucopians and others became incautious, less from greed than from a fundamental uncertainty about the productivity innovations affecting their country and the economy's dynamic response to them. Cornucopians knew they were wealthier, but not by how much or for how long.

When productivity first began to improve, they increased their saving rate, content to save more today in return for expanded future consumption. As this cycle of virtue lengthened, however, they became increasingly willing to lower their saving rate. After all, large direct holdings of stock or large indirect holdings in pension accounts had made many people wealthy. If productivity would be even greater in the future, why defer consumption when you can have more today *and* more tomorrow?

In a closed economy, consumption and investment growth rates cannot increase simultaneously for long because investment must be

financed by savings, the part of income that is not consumed. Cornucopia's open economy could support both expanding consumption and investment growth rates because foreign investors were flocking to its stock market. With their currency's buying power increasing on foreign exchange markets, Cornucopians could buy imports cheaply. Foreigners were willing to exchange their current production for a claim on the future output of Cornucopians, who, for their part, were eager to sell foreigners claims on their future production because they expected to have such bounty.

Meanwhile, naysayers and skeptics preached the demise of this virtuous cycle. Some predicted accelerating inflation, others expected a slowdown in consumption, and all worried about the stock market's viability. But the boom thundered along, ushering in a New Age for Cornucopia. Luxury cars jammed traffic, planes jetted people to ever more exotic vacations and second homes, cell phones chirped on golf courses, and sophisticated medical care prolonged the length and joy of life.

In retrospect, the end of the boom was no surprise; in fact, many people were relieved when it came. Because of Henri Lagnippe and his fellows, Cornucopians had certainly become legitimately wealthier, but not by nearly as much as they'd believed. They had persuaded themselves that increases in corporate profits were sustainable, but in truth the permanent portion of that growth was only a fraction of the initial spurt. They drastically overbuilt their capital stock, including housing and durable goods, and borrowed against the future to finance it. Once it became clear that profit growth was slowing down, equity values fell and people felt less wealthy. Investment halted in its tracks. The cycle that had spun virtuously along turned vicious.

Despite its setback, Cornucopia remains a wealthy country to this day. Nevertheless, its people suffered through a period of hardship that could have been avoided if the boom had been tempered. Fortunately, people were not in a mood to look for scapegoats, because they believed they had mostly themselves to blame. Even more fortunate were those who might have served as scapegoats, because they believed they might have made a difference. And everyone lived somewhat happily ever after.