

Short-Term Gain for Long-term Pain – The Real Story of Rubinomics

By Dean Baker, Center for Economic and Policy Research

Abstract

During the Clinton years, the stock market reached historically unprecedented price to earnings ratios, the dollar rose to a value against the currencies of U.S. trading partners that was clearly unsustainable, and housing prices were vastly outpacing the overall rate of inflation for the first time in the post-war era. These trends created the appearance of great prosperity: the stock bubble created \$8 trillion in imaginary wealth, the inflated dollar led to a flood of cheap imported goods, and the housing bubble led to several trillion dollars of additional bubble wealth. In the long-run all three of these trends were clearly unsustainable and would lead to painful adjustment processes.

This paper will explain the dynamics of each of these bubbles and how each was easily recognizable at the time it developed. It will then outline the nature of the long-term costs associated with the collapse of each bubble. In the case of both the stock and housing bubble, the direct effect of the bubble includes hundreds of billions of dollars of misdirected investment. It also led to record low private savings rates, as households consumed based on transitory bubble wealth. The long-term effects will prove especially harmful since the bubble years coincided with the peak savings years of the massive baby boom cohort.

The macroeconomic adjustment process to the loss of bubble stimulated demand is also likely to be long and painful. It is also likely to be accompanied by financial crises, most notably with the collapse of the Pension Benefit Guaranty Corporation and severe strains facing Fannie Mae and Freddie Mac.

The collapse of the dollar bubble will lead to a sharp rise in import prices, which will in turn lead to higher inflation in the United States. This is likely to lead to a period of high interest rates and slow growth. Rising import prices will also likely slow productivity growth, just as falling import prices likely contributed to the productivity upturn in the late nineties.

In short, the United States is likely to pay a substantial price over the long-term for the bubble induced prosperity of the late nineties. Allowing, or even encouraging, the growth of these bubbles was one of the greatest mistakes in economic policy in the history of the United States.