

Wall Street Moves Main Street

By BURTON G. MALKIEL

As the stock market continues its erratic gyrations—with the Dow Jones Industrial Average dropping 207 points one day last week, only to regain its ground fitfully since then—anxiety mounts that a profound correction is overdue. In such a situation, it is important to consider the effect the stock market has on the real economy. Are Wall Street and Main Street closely linked, or is the stock market simply a gambling parlor unconnected to real economic activity? Has the stock market boom contributed to the long economic expansion over the past several years, and would a decline jeopardize this growth? To answer these questions, one must first understand the ways in which stock prices affect economic activity.

There are three paths through which stock prices influence the real economy. Higher prices boost people's wealth and thereby tend to increase consumer spending. High stock values also lower businesses' cost of equity capital and thereby tend to increase investment spending. Finally, a booming stock market tends to increase both consumer and business confidence. Low stock prices have exactly the opposite effects, and would therefore depress economic activity.

Wealth Effects

Consumer spending has been the main engine of the current economic expansion. Consumption expenditures have undoubtedly been stimulated by both rising incomes and rising wealth. Stocks now represent the largest component of assets on household balance sheets, surpassing the value of real estate. But the relationship between the height of the stock market and consumer spending is one of the less predictable relationships in economics. Estimate of the propensity to consume stock market wealth range widely—from one

cent to five cents per \$100 of wealth. Many analysts believe that spending propensity has declined in recent years.

Consumers' responses to increases in stock market wealth may now be muted for two reasons. First, an increasingly large proportion of household equity is held in relatively inaccessible tax-favored savings and pension plans that carry penalties for early withdrawal. Second, stocks held outside retirement plans tend to be concentrated among the wealthiest households. This suggests that whatever wealth effect

the stock market sends signals about the appropriate cutoff or hurdle rates firms must surpass to justify new investments.

Again, while the direction of the influence of stock prices on business investment is clear, the magnitude of the effect is highly uncertain. But economists at Goldman, Sachs & Co. believe that stock prices have a strong influence on business investment. They estimate that the real cost of capital has declined by about 24% from early 1995 through early 1998 and this in turn has boosted investment by

prices rise to "unreasonably high" levels, the chances of a sharp decline increase. Therefore, they argue, the Federal Reserve should tighten monetary policy now to deflate the market.

I disagree. The Fed's job is to influence aggregate demand and to help it grow at a sustainable noninflationary rate—not to try to set a target for the industrial average. Moreover, neither the Fed nor anyone else knows when stock prices are "unreasonably high"—even though I myself worry that the earnings-growth expectations embedded in today's stock prices may be too high. I am certain that mutual-fund investors who expect persistent 20% to 30% annual rates of return on equities will be disappointed.

The Fed's Job

But "bubbles," if they exist, are only known in retrospect. Moreover, even if one "knows" that stock prices have risen to wildly excessive levels, no one has any idea how to let the air out of a bubble slowly. And bursting the bubble is unlikely to improve economic performance.

The paradox is that the stock market is at its current levels in part because the economy has performed so spectacularly. The Fed must watch asset markets closely as it forms judgments about whether aggregate demand will grow too quickly. And if markets experience sharp corrections, the Fed will have to gauge how much this will depress aggregate demand and act accordingly, as it did in October 1987. But monetary policy must be set by conditions in the real economy, not by the levels of stock prices on Wall Street.

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there is may be confined to spending on luxury goods and consumer durables.

No one knows for sure what the effect on consumer expenditures would be of a sharp decline in stock prices. On the one hand, even a large drop would leave stock prices far above the levels of early 1996 and would be unlikely to scare investors into spending less. On the other hand, some analysts have argued that the effect of falling stock prices may be asymmetrical, with a consumption contraction far greater than the spending surge generated by a market boom. Thus, while the direction of change is probably clear, the magnitude of the economic effect is less certain.

The second route by which stock prices influence the real economy is through the signals the market sends about the cost of equity capital and its effect on business investment. A rise in share prices makes it less expensive for firms to raise capital in the equity market since it takes fewer shares to raise a given amount of funds. Even if a firm does not issue new shares,

12% and increased the economy's growth rate by four-tenths of a percentage point annually.

A third and related effect of fluctuating stock prices is on consumer and business confidence. Rising stock prices make everyone more confident; sharp declines in stock prices create anxiety and can dampen spending propensities. Economist Paul Samuelson famously remarked that "the stock market has 'predicted' nine of the last five recessions." But the market is still widely used as a leading indicator of future business conditions. A very sharp decline in prices could deal a serious blow to America's long economic expansion. Businesses might terminate or postpone major projects, and consumers may refrain from buying big-ticket items and second homes.

So Wall Street and Main Street are closely related. Were the market to suffer a substantial decline, consumption and investment spending would undoubtedly be affected. Some analysts worry that if stock