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Fear Itself

The economy of 2001 is a bust. Do we have only ourselves to blame?

Christopher Ragan
McGill University

During the depths of the Great Depression in the early 1930s, U.S. President Franklin Roosevelt said in his inaugural address "we have nothing to fear but fear itself." Accordingly, his initial policies were aimed at restoring Americans' confidence. Like some giant spoon-bending exercise, Roosevelt seemed to believe that the health of the economy was so flexible that it could be willed in any direction, as long as millions of consumers and businesses put their minds to it. Can the economy be shaped by a nation's beliefs?

This question has become especially relevant to Canadians, since the boom economy of 1998-2000 seems to have suddenly disappeared, replaced by the bust economy of 2001. Every few days it seems that another major company is announcing large-scale layoffs. "Recession" is on everyone's lips.

Who or what is in the economy's driver's seat? Most Canadian firms announcing layoffs, including new-economy giant Nortel and old-economy giant GM, have blamed their downsizing on the rapid slowdown in the U.S. economy. This is entirely sensible. Since Canada exports 35% of its annual output to the United States, a significant slowdown there means a large reduction in demand for our products. But this begs the more basic question: what has caused the U.S. economic slowdown?

To begin with, all kinds of things can cause a recession. A dramatic increase in tax rates can reduce consumer expenditures and depress business investment. A persistent increase in interest rates can also do it, as can a sustained decline in foreign demand for exports. The trouble with these explanations in this instance is simple — none of these events has happened in the past year. In fact, it is difficult to point to any set of tangible economic events responsible for triggering the U.S. economic slowdown. So what remains as an explanation?

Maybe it's fear — Roosevelt's old enemy. Economic outcomes are the result of decisions made by millions of consumers and businesses. Those decisions are heavily influenced by expectations about the future because consumers and firms that are pessimistic about the future are less likely to spend and invest. This pivotal role played by expectations means the economy is subject to self-fulfilling prophecies. In other words, fear — all by itself — can cause recessions. Here's a simple example.

Suppose a bunch of corporate managers suddenly feel pessimistic about their firms' economic future. For a Texas or Alberta oil producer it may be a guess that the world price of oil will fall. For a Michigan or Ontario auto producer it may be a belief that interest rates will rise. For a Maine or Quebec paper producer it may be a hunch that foreign demand for its product will fall. The managers may respond to these pessimistic beliefs in slightly different ways for all kinds of reasons, but they will share one thing in common: none of them will embark on new investment projects, and some will probably cancel or delay projects already in the works. Pessimism therefore leads investment spending to fall. But that's not the end of the story.

This decline in investment spending is a decline in the demand for goods and services that would have been used to expand explorations in the oil patch, run the extra shift in the auto plant, or expand the paper mill. If this decline in demand lasts for a while, supplying firms will scale back production and lay off workers, and so production and income will fall. The decline in income leads households to curtail purchases and, as sales fall, leads other firms to scale back their investment plans. Add to this the confidence-shattering effects of the stock-market collapse that accompanies large-scale layoff announcements and we have a vicious circle that is hard to break.

Pessimistic beliefs can therefore lead firms to act in a way that brings about economic conditions that, in turn, justify the initial pessimism. In other words, the expectation of a recession can itself create a recession. Franklin Roosevelt was right about the importance of fear.

To make matters worse, self-fulfilling prophesies can be created out of thin air. Firms' or consumers' expectations about the economy can be utterly baseless initially but can end up being "rational expectations," in the lingo of economists. Perhaps there was no good reason to expect oil prices to decline or interest rates to rise or the demand for paper to fall. The beliefs could have the most flimsy foundations, or be based only on superstition. It simply doesn't matter. What does matter is that the pessimism leads to lower spending. And as long as the pessimism is sufficiently widespread, we get a large enough decline in demand to create a recession. The recession justifies the initial, apparently groundless, pessimism.

Fortunately, what is true about pessimism creating recessions is equally true about optimism creating booms. This explains why Paul Martin is so eager today, just as Roosevelt was 70 years ago, to prop up the level of consumer and business confidence. You've noticed how often Martin tries to "talk up" the Canadian economy. As long as confidence can be maintained, consumers and firms can be trusted to keep on spending. With demand remaining high, firms will respond by increasing production, and the greater income and economic activity will justify the initial bit of optimism. This is the self-fulfilling prophecy working in the other direction — a virtuous circle.

So the next time you hear Paul Martin courageously talking up the Canadian economy, even amidst widespread corporate layoffs, you will understand what he is trying to do. And you should sympathize with the enormity of his task. Given the existing U.S. slowdown and the resulting decline in demand for Canadian exports, combined with the rapid decline in confidence that has accompanied the recent turmoil in the stock market, it's going to take a large increase in domestic spending to keep the Canadian economy on an even keel. Martin is hoping that lots of positive talk — combined with a little more government spending, the income-tax cuts announced last year, and lower interest rates from the Bank of Canada — will be sufficient to do the trick.

Unfortunately, Paul Martin may face one challenge too many. With a little luck, he will be able to keep 30 million Canadians confident about their economic future. But unless someone is keeping 300 million Americans equally confident about theirs, Martin's efforts may be in vain.