Bubbles, Memory and Governments

↳ By Alex J. Pollock

It does not seem possible that in a reasonable, let alone a rational, world, housing bubbles or other financial bubbles could actually happen. Yet obviously they do, and indeed happen fairly frequently, historically speaking, always followed by a bust. They provide us an enduring and fascinating puzzle.

The United States had two housing finance collapses, in the 1980s and 2000s, in the space of three decades, with a tech stock bubble in between in the 1990s. Japan had giant, simultaneous bubbles in real estate and stocks in the 1980s, whereas the U.S. bubbles were sequential. Europe joined in during the 2000s with housing bubbles in England, Ireland and Spain, and then a bubble in the sovereign debt of weak governments, notably Greece. All these historically recent bubbles happened in advanced financial systems, with plenty of information, computers, financial models, analysis, rating agencies, well-educated bankers and investors, ever-busy government regulators and supposedly stabilizing central banks.

These are just a few of a great many financial crises: the International Monetary Fund counted 147 banking crises around the world since 1970. Carmen Reinhart and Kenneth Rogoff's list of banking crisis since 1800 is 45 pages long.

It is eleven years since the mid-2006 peak of house prices in the spectacular 21st century U.S. housing bubble. Ten years ago, in mid-2007, the deflation of that bubble had begun. At the time, prominent voices, including the Chairman of the Federal Reserve and the Secretary of the Treasury, were denying that there would be a financial crisis. Nevertheless, there was.

New generations who were teenagers in 2006 and not yet born in 1980 are joining the housing finance, banking and investment ranks. Stock and bond prices have soared, with central banks manipulating interest rates to historic lows and stock market indices making record highs. For those who did live through the last bubble, memories will be growing less sharp and in time will fade and optimism grow. U.S. house prices have been rising for five years and are back over their 2006 peak in nominal dollars. In Canada, which survived the last crisis well, house prices and household debt are at all-time record highs.

"The mercantile community will have been unusually fortunate if during the period of rising prices, it has not made great mistakes," wrote Walter Bagehot in his 1873 banking classic, Lombard Street. True then, true now. (The "mercantile community" of course includes the banks.)

Bagehot continued: "Such a period naturally excites the sanguine and the ardent; they fancy that the prosperity they see will last always, that it is only the beginning of a greater prosperity. They altogether over-estimate the demand for the article they deal in, or the work they do. They all in their degree – and *the ablest and cleverest the most*… trade far above their means."

"Trade far above their means" means they take on too much debt. I have italicized "the ablest and cleverest the most" to emphasize the role of many of the smartest people in inflating the bubble. Some of the most intelligent people can make the biggest mistakes. Professional investment managers feel they have to join the party or be left behind. "Fear of missing out strikes terror into the heart of portfolio managers," as a recent market commentary said.

So, as Bagehot observed, "Every great crisis reveals the excessive speculations of many houses which no one before suspected, and which I indeed had not begun or had not carried very far those speculations, *till they were tempted by the daily rise of price*."

When a bubble is expanding, and prices seem to be inexorably rising, even conservative savers and investors, and careful borrowers, after a while begin to feel the temptation of the price rises. They come to doubt the wisdom of their conservatism. At every dinner party, they have to listen to other guests telling about how much money they have made in the speculations of the bubble, and how they made even more if they are using borrowed money – by flipping houses with 100% loans, for example, or buying stocks on maximum margin. Finally, the conservative savers may come to feel like suckers: "Why am I always missing out?"

Envy is one of the seven deadly sins, but it is hard for the conservative savers not to feel it at these dinner parties. If on top of that, they are feeling stupid, the combination of envy and feeling stupid is hard to bear. As was sardonically observed by economic historian Charles Kindleberger, "There is nothing so disturbing to one's well-being and judgment as to see a friend get rich." However, there is one thing even more disturbing than that: to see your brother-in-law get rich!

The result is that the conservative savers may finally plunge in at the top of the housing or equity or bond market and live to regret it.

Wealth is measured by the prices of things. But what is a price? It is an agreement among parties to exchange a certain amount of money for something at a particular point in time – a house, land, some stocks, junk bonds, gold, or anything else. The price has *no objective existence*, and needless to say, the price of any investment asset can change a great deal. They go up much more than expected in the boom, and they fall much more than expected in the bust.

In a bubble, prices and wealth are an illusion created by the bubble. When bubbles collapse and shrivel, people are said to have "lost their wealth." But they haven't really lost it, since it was never really there.

If the dizzying rise in prices, so disturbing to the judgment, has been heavily financed by banks, the panicked fall of prices will force major losses on the banks. This creates dilemmas for the governments involved. Should they protect the depositors in the banks by bailing out the banks, or let the correction of the now-evident pricing mistakes impose huge and widespread losses as the bubble prices evaporate? Facing great uncertainty and the possibility of a generalized collapse, modern governments always decide to intervene and use the taxpayers' credit and money to offset the losses of the financial firms in the name of financial stability.

The 21st century bubbles, their shriveling, and the large government interventions that followed, have filled dozens of books and memoirs, hundreds of articles, and untold hours of media babbling. But the debates about whether governments should save the financial firms sunk by their price speculations goes back at least to 1802, when Henry Thornton, in *The Nature and Effects of the Paper Credit of Great Britain*, discussed the issues.

Key to the problem is that people all over the world long for their bank deposits to be risk free. But these deposits fund businesses which are inherently very risky. This is especially true in the financing of real estate.

In principle and in fact, it is impossible to make riskless deposits out of the risky business of banking and mortgage lending. But governments everywhere insist on trying to do it anyway. They are therefore frequently put in the position of wanting to protect depositors by moving losses from the lending institutions to the taxpayers, as was again prominently the case in the last crisis. Also, by moving interest rates to near zero, and keeping them negative in inflation-adjusted terms, governments shift the losses to savers. I estimate that the interest rate policy of the Federal Reserve has cost U.S. savers more than $2 trillion since 2008.

Since bubbles are a recurring reality and memories always fade, the risks can only be moved to different forms and imposed on different people, not eliminated, and there can be no absolute safety. So it is, and so it will be.

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