

The Next Bubble: Can There Be a Policy Response?



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Four Questions to Answer



- What is a bubble and can policy makers see one?
- Why do bubbles occur?
- Do the risks associated with a bubble rise to a level meriting a policy response?
- Can the government intervene effectively to respond to a bubble?

What are Bubbles and Can They Be Seen?



- A bubble arises when there is a significant divergence between the market price of an asset and its value based on fundamental determinants.
- Examples:
 - **Equities:** prices that bear no relationship to the present value of expected future cash flows/profits
 - **Housing:** prices that no longer reflect fundamental sources of underlying demand.
 - **Commodities:** rapid price increases unrelated to their value in alternative uses.

Can a bubble be seen?

- There was ample evidence that there was a bubble in housing prices before 2008, and there was ample evidence of a bubble in Internet stock prices during the Dot Com boom.

Why Do Bubbles Occur?



- Understanding the difference between “stock” markets and “flow” markets is key to understanding bubbles.
- Pricing
 - Pricing in “flow” markets is determined by the interaction of production (supply) and consumption (demand)
 - Pricing in “stock” markets is determined by fixed supply interacting with variable demand
- When demand increases
 - “flow” markets respond with an increase in price and supply
 - “stock” markets respond with an increase in price only, and the price increase is a function of increased demand and demand elasticity
- Notwithstanding short term price spikes for “flow” goods (Cabbage Patch Dolls), bubbles occur in “stock” markets

Do Bubbles Merit a Policy Response?



- Some bubbles do and some do not
 - Does a bubble risk triggering a systemic event?
 - Does the government have the data and analytical tools, not just to identify a bubble, but to make a determination as to the systemic risk?
- Which bubbles should have triggered a response?
 - Tulips? Gold? Dot Com companies? Housing?
- There is much support -- now -- for the government to have intervened while the housing sector bubble was still growing. However, at the time, such intervention would have been very unpopular.

Government Intervention in Response to a Bubble



- Given the role of increased demand in creating a bubble, government intervention should be directed at reducing demand in the bubble market.
- Case Example - Housing: what could have been done?
 - Reduce availability of mortgage credit with tighter credit underwriting standards
 - Reduce availability of mortgage credit by reducing demand for mortgage assets (i.e. GSE Affordable Housing Goals)
 - Reduce availability of mortgages by raising minimum down payments. Done in Israel last month; MDP raised from 20% to 30%
 - Reduce tax subsidies for housing. I am not talking about the mortgage interest and property tax deductibility, but the incentive to flip houses created by the availability of up to \$500,000 in tax free capital gains on a home sale every three years

Will Government Intervene in Future Bubbles?



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"We just haven't been flapping them hard enough."