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Bubble = recession? Maybe not

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One of the most common perceptions of economics is "if a bubble bursts, the economy is going to follow." However, Vernon L Smith doesn't always agree. In a 2009 Cato Institute article he wrote with Steven Gjerstad, they lay out data on the downtown of 2008 and 1929, to examine how the depressions started.

Smith opens the essay by commenting on the formation of bubbles. The initial theories on bubble formation believed that they were due to non-transparent markets, but modeling showed that to be wrong. This is believed to happen due to buying on prince trends instead of the strict value, and results in a regular rise and fall of market bubbles. However, with this knowledge, one needs to test the idea of bubbles causing recessions. The dot-com bubble did little damage to the overall economy, while the housing bubble tanked it. Smith and Gjerstad posit that the housing market in particular has the key characteristics needed to crash the overall economy: characteristics like high margin purchases, momentum trading, liquidity, and price-tier movements.

The housing market in the early 2000s was a unique set of circumstances that brought about incredible growth, but at the cost of almost all market stability. Prices has begun to rise after the latest slump in the early 90s, kicked off by rising income and lower tax rates. It managed to survive the 2001 recession mostly intact, due to an expansionary policy from the Fed with record low rates, as well as eroding credit standards. These allowed for numerous risky mortgages, keeping the price rising, and creating a self-fulfilling prophecy of pricing based on inflation. However, since income was not rising at these same exponential rates, this was not sustainable long-term growth.

As the bubble started to crash and the housing market began to fail, the effects reached through into the main economy. Smith hypothesized that it is the focus of the crash on debt, and especially lower income debt, that is so painful. Like the Great Depression in the 1920s, the rapid defaulting on loans hit banks and the financial sector extremely hard, slashing investment and sending financial security plummeting.

This occurring in the partially volatile lower income sector, where losses hurt far more, was just icing on the cake. This, Smith and Gjerstad point out, was the difference between the equites crash of 2002, and the housing crash of 2006, and why one hurt far worse: One just hits harder.

I agree with Mr. Smith and Mr. Gjerstand, and I find their in depth examination of the numbers enlightening, even if slightly dense. The similarities are notable to the Great Depression with the

emphasis on failing banks and a declining financial sector. I'm curious what they would say about the recession over COVID-19. It seems to be caused less by a collapse in a certain market, and more by a general drop in productivity. This is indicative of the difference in recession cause, but the similarity in outcomes and recovery is interesting. I wonder if it would ever be more efficient to tailor rebuilding plans to the cause, something that can really only be determined with further studies and testing.