Luminaries Rethink Housing Bubbles

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By Robert Feinberg

A distinguished panel assembled at the Cato Institute recently to reconsider the state of housing bubbles in the U.S. and their relationship to the economic cycle. The featured authors were Nobel Laureate Vernon Smith of Chapman University, a senior fellow at Cato, and Steven Gjerstad, a presidential fellow at Chapman. The two presented their new book, Rethinking Housing Bubbles: The Role of Household and Bank Balance Sheets in Modeling Economic Cycles.

In his introduction, Mark Calabria, director of financial regulation studies at Cato, referred to the "unique" role of the housing bust as a contributor to the 2008 episode of the ongoing financial crisis. He summarized this circumstance with two observations: 1) markets with the characteristics of housing regularly display bubble behavior, and 2) housing has nearly always played this role in postwar U.S. recessions.

Smith declared that the authors did not come to this subject from the standpoint of traditional macro or monetary economics, but they became intensely interested in the relationship between the Great Recession and hundreds of bubbles they have observed in the laboratory. They expected to find that the Great Recession was an "outlier" in terms of the role of the housing bubble, but they went back to the Great Depression and looked at the postwar recessions and found that the Great Depression and Great Recession both stood out as to the influence of balance sheets of households and banks.

The authors identified 1997 as the takeoff point of the bubble that led to the 2008 crisis episode and attributed that takeoff to the Tax Relief Act of 1997, when the Clinton administration sought to upstage Republicans by proposing a $500,000 tax-free capital gain exemption for houses held for two years. Subprime mortgages, mortgage-backed securities and derivatives were layered on top of this sweet tax benefit as additional fuel for the boom in house prices. House prices turned down in 2006 and crashed through the fixed-mortgage debt that financed those houses.

The authors credited programs designed to help the middle class accumulate wealth with working until the bubble collapsed. Smith found in looking at the Depression that prices don't have to show a great rise in order to suffer a serious collapse. The authors assert that while household and bank balance sheets are constrained, fiscal and monetary policy become ineffective until those balance sheets recover.

By contrast, the authors found that stock market crashes do not damage balance sheets to the

same extent, because balance sheets are cleaned up in real time, and the Federal Reserve didn't understand this. They go on to say that the ordinary cycle of consumer spending never causes a crash.

In his commentary, Dean Baker, co-founder of the progressive Center for Economic and Policy Research, highlighted the fact that the worst excesses of the bubble were perpetrated by the private issuers of mortgage-backed securities — Goldman Sachs, Citigroup and Morgan Stanley, rather than Fannie Mae and Freddie Mac. (This writer would suggest taking a closer look at the relationship between Goldman and the government-sponsored enterprises, and perhaps the distinction is not so clear. Ultimately the three banks were treated as government-sponsored enterprises along with Fannie and Freddie, so to call them private institutions might be a bit misleading.)

Baker also finds support in the book for bailing out homeowners rather than banks. He attacked as "boneheaded" the first-time homebuyers' tax credit that was attached to the stimulus package that took effect in March 2009, which lured millions of people into the extended bubble, with the main beneficiaries being bailed-out banks. He smacked former Treasury Secretary Tim Geithner for taking credit for this temporary, unsustainable, costly boost. And he disagreed with the authors' minimization of the effect of the dot-com bubble but rather found that it contributed to flat job growth until the housing bubble took effect.

Readers are left to ponder where the fuel is going to come from for restoration of growth as long as the dead weight of legacy debt remains. What could be in store is a lengthy Japanese-style stagnation while zombie banks are indulged in the opportunity to work off unrecognized losses.

(Archived video can be found **here**.)