Booming Until It Hurts?

By Robert Shiller *Thu, Jul 24, 2014*

As usual, the stock market appears to be climbing a wall of worry. This 2013 Nobel laureate believes that such worries are healthy, but only as long as they don't fuel an over-reaction to the next downturn.

In recent months, concern has intensified among the world's financial experts and news media that overheated asset markets—real estate, equities, and long-term bonds—could lead to a major correction and another economic crisis.

The general public seems unbothered: Google Trends shows some pickup in the search term "stock market bubble," but it is not at its peak 2007 levels, and "housing bubble" searches are relatively infrequent.

But the experts' concern is notable and healthy, because the belief that markets are always efficient can survive only when some people do not completely believe it and think that they can profit by timing the markets. At the same time, this heightened concern carries dangers, too, because we do not know whether it will lead to a public overreaction on the downside.

International agencies recently issued warnings about speculative excesses in asset markets, suggesting that we should be worried about a possible crisis. In a speech in June, International Monetary Fund Deputy Managing Director Min Zhu argued that housing markets in several countries, including in Europe, Asia, and the Americas, "show signs of overheating." The same month, the Bank for International Settlements said in its Annual Report that such "signs are worrying."

Newspapers are sounding alarms as well. On July 8, the New York Times led its front page with a somewhat hyperbolic headline: "From Stocks to Farmland, All's Booming, or Bubbling: Prices for Nearly All Assets around World Are High, Bringing Economic Risks." The words "nearly all" are too strong, though the headline evinces the newfound concern.

It is not entirely clear why the alarms are sounding just now, after five years of general expansion in markets since they hit bottom in early 2009. Why aren't people blithely expecting more years of expansion?

It seems that this thinking is heavily influenced by recent record highs in stock markets, even if these levels are practically meaningless, given inflation. Notably, just a month ago the Morgan Stanley Capital International All Country World Index broke the record that it reached on October 31, 2007.

The International Monetary Fund announced in June a new Global Housing Watch website that tracks global home prices and ratios. The site shows a global index for house prices that is rising, on a GDP-weighted basis, as fast as during the boom that preceded the 2008 crisis, though not yet reaching the 2006 record level.

There is also the US Federal Reserve's announcement that, if the economy progresses as expected, the last bond purchase from the round of quantitative easing that it began in September 2012 will be in the month after the Federal Open Market Committee’s October 2014 meeting. That kind of news story seems also to affect observers’ thinking, though it is not really much in the way of news, given that everyone has known that the Fed would end the program before long.

The problem is that there is no certain way to explain how people will react to such a policy change, to any signs of price overheating or decline, or to other news stories that might be spun as somehow important. We simply do not have much well-documented history of big financial crises to examine, leaving econometricians vulnerable to serious error, despite studying time series that are typically no more than a few decades long.

Until the recent crisis, economists were talking up the “great moderation”: economic fluctuations were supposedly becoming milder, and many concluded that economic stabilization policy had reached new heights of effectiveness. As of 2005, just before the onset of the financial crisis, the Harvard econometricians James Stock (now a member of President Barack Obama’s Council of Economic Advisers) and Mark Watson concluded that the advanced economies had become both less volatile and less correlated with each other over the course of the preceding 40 years.

That conclusion would have to be significantly modified in light of the data recorded since the financial crisis. The economic slowdown in 2009, the worst year of the crisis, was nothing short of catastrophic.

In fact, we have had only three salient global crises in the last century: 1929-33, 1980-82, and 2007-9. These events appear to be more than just larger versions of the more frequent small fluctuations that we often see, and that Stock and Watson analyzed. But, with only three observations, it is hard to understand these events.

All seemed to have something to do with speculative price movements that surprised most observers and were never really explained, even years after the fact. They also had something to do with government policymakers’ mistakes. For example, the 1980-82 crisis was triggered by an oil price spike caused by the Iran-Iraq war. But all of them were related to asset-price bubbles that burst, leading to financial collapse.

Those who warn of grave dangers if speculative price increases are allowed to continue unimpeded are right to do so, even if they cannot prove that there is any cause for concern. The warnings might help prevent the booms that we are now seeing from continuing much longer and becoming more dangerous.

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