Asset Price Bubbles And How to Save the Real Economy from Them

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Asset price troubles

- Buildings. Shares. Currencies. Metals.
- Prices often move without any obvious justification.
- People get surprises. Many complain about high house prices, or suffer from unexpected collapse of share values.
- The American and Spanish house bubbles “burst”, causing a credit famine, with serious consequences.

Asset prices in theory.

- Consider an unproduced, indestructible asset, e.g. land or dollars. Ignore uncertainty.
- What is the price. Supply equal demand?
- Demand now depends on anticipated future price; which depends on further future price; and so on for ever.
- Since price never negative, can’t be too low.
- Otherwise anything is possible.

No theory, so...?

- Keynes pointed this out: “beauty contest”.
- The consequence is excess volatility.
- And the impossibility of economic forecasts.
- Real uncertainty. Worse. People have to guess future prices in many different circumstances.
- Economists think price should be the “fundamental”. The lowest sensible price.
- Otherwise people must think prices will be growing faster than rents. Why not?

Fundamentals

- Can’t always define the fundamental.
- For property, the discounted sum of future rentals (or equivalent).
- Currencies? Obviously should not be zero. Purchasing power parity? Imprecise.
- Company shares? Discounted dividends? Profits may be retained. Might go on for ever.
- Even if the fundamental can be defined, price can greatly exceed it.

The volatility problem

- Does the volatile, indeterminate price matter?
- Not according to standard economic theory.
- Rental markets are needed, to allocate the use of assets like land. No need for property markets.
- Countries could use a common currency.
- Companies could issue shares for a year.
- All because the standard model does not allow for default and security concerns.

Why asset prices matter

- In reality, asset prices affect
  - Credit. especially by limiting collateral.
  - The wealth distribution.
- And assets store savings. (Though finite-life assets could do that.)
- When banks found their assets were worth much less than before, they had to rebalance their portfolios, and reduced lending, so that demand fell, unemployment grew.

Artificial uncertainties.

- Price volatility creates doubt and uncertainty.
- And provides a basis for gambling, which redistributes wealth, increasing inequality.
- Uncertainty about savings affects savings decisions and outcomes. People save more than they should need to, and suffer when asset prices fall.
- Foreign exchange uncertainty also makes people insure in various ways – at a cost.

Currency Unions

- Mundell argued that multiple currencies create artificial uncertainty, so that we would be better off without them.
- But currency movements are easier than wage corrections. See what trouble the Euro has created.
- Therefore not always good to eliminate asset markets.

Produced Assets

- Land can be created. Building sites are prepared. Company brands are built.
- Prices are undetermined.
- Now, prices affect production decisions.
- Price can be below the optimal level, as well as above.
- Identifying the optimal price requires calculation of an economic model. Depends on welfare judgments.

Reducing volatility

- How can we reduce volatility?
- Closing the market, e.g. nationalizing land? Should help, though speculation seems to affect finite leases too.
- Interest rates? Uncertain effect. And they have other tasks.
- Analysis and prediction. The predictions will have to be successful: is that possible?

Taxes and trades

- Transaction taxes are popular.
- No reason why they should work, except that people may believe they will.
- They should reduce the frequency of fluctuations, rather than magnitude.
- Intervention best? – e.g. currencies. (Inconsistency a problem.) Even housing, despite the inefficiencies (stubborn expectations a problem).

Living with volatile asset prices

- It seems we need to learn to live more easily with asset prices.
- Loan/value ratios can be regulated.
- Leverage and short-selling could be reduced, partly prohibited.
- Restrict banks to old-fashioned business.
- Tighten default conditions, especially in USA.
- Companies still need to be bought and sold!