

## Occasional Essays on Current Policy Issues No. 21

### **The Trouble with Bubbles**

Stephen G. Cecchetti\*

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Central bankers keep inflation low, real growth high and the financial systems operating smoothly by using a combination of data and their own instincts to move before things get bad. Pre-emptive action based on hunches and suspicions rather than hard facts, is in monetary policy makers' blood. So why is it that Alan Greenspan and his colleagues at the Federal Reserve remain steadfast in their view that trying to head off asset price bubbles, with their obviously disastrous consequences, is not in their department?

Recent Japanese and American experiences have taught us important lessons about the way asset price bubbles distort economic and financial decisions. The costs are enormous.

Take the US case. America's internet bubble led to overinvestment in high-technology companies, affected tax policy, pension investment decisions and even the measurement of output. We all know about the misallocation of investment resources and the several-trillion-dollar run rise and fall in stock market wealth. It is the other results that have come to light more recently and may have more lasting effects.

As stock prices rose, capital-gains taxes filled the coffers of local and federal governments in America. With all the extra money, politicians could increase spending while cutting taxes. And they did it as if the revenue growth was permanent. Now that the bubble has burst and tax collections have collapsed, legislators are stuck with very unpopular alternatives. Do they raise taxes, cut spending or increase debt? With the economy sputtering along, the first two options look pretty bad. But borrowing is unavailable to almost everyone bar the federal government in Washington, and even there it is unclear how wise it is. The internet bubble created these problems, and they surely involve hundreds of billions of dollars.

Underfunding of Social Security, the US public pension system, has been a problem for years. And now we learn that the stock market boom and bust has created trouble for the private system. When high stock returns drive up the accumulations in these private funds above the level that actuaries say they need, the sponsoring companies are allowed to make withdrawals. These "negative" pension contributions increase company profits, driving stock prices even higher.

Needless to say, a lot of this went on during the late 1990s. With the stock market falling, these pensions have become underfunded and so companies are now forced to put the money back in - money that, if it were not for the bubble, would never have been withdrawn in the first place. Today, some say the size of the problem is about \$100bn.

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In a more subtle way, the bubble drove up measured gross domestic product growth. Much of the overinvestment in the US economy has been in computer equipment. Companies purchased and installed more machines than they needed. And these essentially worthless computers, representing extremely fast productivity growth, made up an ever-increasing portion of output. Part of America's new economy miracle, with its 4 per cent and above growth rates, now looks as if it was partially a statistical mirage: US potential growth is 3 per cent, more than a full percentage point below the level people hoped for just two years ago. That affects both public and private decisions at all levels.

Add all of this together, and the cost is several per cent of US GDP and still counting. When faced with the potential for output losses of this size, central bankers usually work fast to try to minimise the damage. So why is it when faced with strong evidence of a bubble they react so differently, claiming that there is nothing they can do? The response is surprising.

Policymakers are usually not shy about intervening in the economy when faced with hard problems. These are the people who raised interest rates in winter 1994 when they had deep suspicions that inflation was going to go up and lowered in autumn 1998 when they thought that the financial system was teetering on the edge of a cliff. From today's vantage point, these decisions continue to look like the right ones.

Central bankers make two arguments for ignoring asset price bubbles. They say that there is no way to be sure that there is a bubble out there and, even if there is, they say there is nothing they can do about it.

The first argument rings hollow. Just because something is hard to measure, that does not mean you can ignore it. For example, it is impossible to avoid forecasting inflation and growth, activities that are certainly not for the statistically squeamish. Beyond that, it is important to realise that buried in the bowels of the forecasts are implicit or explicit estimates of the asset prices, the implied equity premium and any potential bubble. These are necessary inputs into any forecast of consumption, investment, overall growth and aggregate inflation. Why not just admit that you take a position on future asset prices and be done with it?

What about the second argument? The most common line of reasoning is that the best monetary policy can do is to react to changes in inflation forecasts. But to the extent that those forecasts are correct, they will show inflation falling after the bubble bursts and the result is actually perverse.

Taking explicit account of the bubble by tightening is a sound alternative. To the extent that bubbles arise from unrealistic expectations of future economic growth, interest-rate increases that moderate current levels of growth can put a break on them. I believe that we are now paying the price for the Federal Reserve's failure to contemplate such action in the spring of 1997. If the Fed had raised interest rates even only slightly - 0.5-0.75 percentage points, say - it would have put a modest break on growth, reduced reported corporate profits and lowered estimates of future revenue growth. With a slower growth forecast, the stock price bubble may have been less extreme.

True, I cannot claim this would have worked - but I certainly should have argued strongly for it at the time.