Sorry to burst your bubble

New research suggests it is debt, not frothy asset prices, that should worry regulators most

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WHEN Chinese shares plunged earlier this month, the government tried frantically to limit the damage. It pumped cash into the market, capped short-selling and ordered share buy-backs. Although China was unusually heavy-handed, it was hardly the first country to try to bolster stock prices for fear of the economic harm a crash could bring. Alan Greenspan, as chairman of the Federal Reserve, famously created the "Greenspan put" by giving investors the impression he would cut interest rates to stop stockmarket routs.

The underlying rationale for these interventions is an idea that until recently received surprisingly little scrutiny—namely, that stockmarket busts are very damaging for the economy. The link seems clear enough in the case of the crash of 1929, which led in short order to the Depression. But it is also easy to point to contrary examples. The bursting of America's dotcom bubble in 2000 wiped out $5 trillion in

Not all bubbles, it would appear, are equally bad. According to two new papers*, the crucial variable that separates relatively harmless frenzies from disastrous ones is debt. In many cases, though certainly not all, stockmarket manias fall into the less worrying category.

Writing for the National Bureau of Economic Research, Oscar Jorda, Moritz Schularick and Alan Taylor examine bubbles in housing and equity markets over the past 140 years. The most dangerous, they conclude, are housing bubbles fuelled by credit booms. The least troublesome are equity bubbles that do not rely on debt. Five years after the bursting of a debt-laden housing bubble, the authors find,

GDP per person is nearly 8% lower than after a “normal” recession (ie, one that is not accompanied by a financial crisis). In contrast, five years after a stockmarket crash, GDP per person is only 1% or so lower. If the stock bubble comes alongside a big rise in debt, the damage to GDP per person is 4%. The paper does not explain why housing bubbles are more costly, but a fair inference is that, whereas equity investments tend to be concentrated among the rich, plenty of people lower down the income ladder have wealth tied up in housing.

That makes sense. Stockmarket routs typically harm the economy via the “wealth effect”. When people see that their assets are worth substantially less than before, they spend less, leading to weaker demand and, ultimately, weaker investment. Debt can make this worse. Those who have borrowed to invest may be forced to sell assets to avoid defaulting, further depressing prices and wealth. Banks that have lent to investors or accepted shares as collateral will also suffer losses. That forces them to rein in their lending, harming the economy even more.

In a paper for the Centre for Economic Policy Research, Markus Brunnermeier and Isabel Schnabel take an even longer view, examining 400 years of asset-price bubbles. Be it tulips, land, housing, derivatives or shares, they find that the consequences of a bursting bubble depend less on the type of asset than on how it is financed. High leverage is the telltale sign of trouble.

What does this mean for central banks? Before the financial crisis, the debate boiled down to “leaning versus cleaning”. Activist sorts argued that the monetary guardians should lean against the wind by raising interest rates when asset bubbles grew. The opposing camp, exemplified by Mr Greenspan, countered that it was too difficult to spot bubbles in advance and too costly to tighten monetary policy erroneously, so it was best to wait for them to burst before cutting rates to help clean up the mess.

Shifting the focus to debt changes the terms of the debate. As Frederic Mishkin of Columbia University has written, policymakers must distinguish between bubbles inflated purely by exuberance and those pumped up by debt. The latter are also easier to identify: credit issuance is abnormally fast and underwriting standards slip. In such circumstances, regardless of the level of asset prices, the case for intervention is strong.

That still leaves the question of what central banks should do after a stockmarket bubble has burst. Those that come to the rescue of collapsing markets are stoking moral hazard. Investors, believing that the central bank will always provide a backstop, are more likely to take unwarranted risks, as American ones did in response to the Greenspan put. Nevertheless, given that stockmarket bubbles accompanied by lots of debt, as in China, can cause severe economic damage, letting them burst without any succour is not a good option either.

Over to the finance minister

One option is to boost the broader economy through a spurt in government spending. Direct intervention to prevent the stockmarket from falling is more problematic, since it gums up price signals, preventing overvalued shares from returning to more reasonable levels. Halting stocks from trading, as seen recently with nearly half of listed Chinese companies, does not eliminate the problem but simply masks it. It was as if America had enacted a moratorium on selling homes after the subprime crisis.

Intriguingly, China’s interventions did put one strand of academic theory into practice. Roger Farmer of UCLA has argued that central banks should buy stocks to keep falling markets at reasonable price-to-earnings (PE) ratios. The Chinese central bank did this by providing cash to a stock-buying fund. Crucially, Mr Farmer says that central banks should then sell their holdings when PE ratios climb too high. That sounds like wishful thinking. In China as in other countries, the central bank often seems more intent on laying a floor for stocks than erecting a ceiling.