NEWS ANALYSIS

The new bubble-prone economy

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The current downturn looks more unsettling than a simple swing in the financial cycle, and traditional remedies might not be up to the task.

By Peter Gosselin, Los Angeles Times Staff Writer

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WASHINGTON -- As presidential candidates and government policymakers rush to offer prescriptions for the deteriorating U.S. economy, some are beginning to worry about a disturbing possibility: This may not be your traditional downturn. And the tools that helped restore prosperity in the past may prove less effective this time around.

Cyclical downturns, including recessions, have long been a feature of the nation's economic landscape after periods of sustained growth. So has one of the most popular antidotes: a fiscal stimulus in the form of tax cuts or higher government spending.

Today, public figures as diverse as Hillary Rodham Clinton, a Democratic presidential contender, and Martin Feldstein, a Reagan administration advisor and conservative Harvard economist, are proposing just that remedy for the current problem: stimulus packages of $50 billion to more than $100 billion.

But such proposals are designed for normal downturns, in which the fundamental problem is that the economy has stalled because consumers have run out of steam or because policymakers have made a mistake, stomping too hard on the economic brakes. Under such circumstances, pumping money into the economy gets it moving again.

In the current downturn, something more unsettling than a traditional swing in the business cycle appears to be at work: The United States has become increasingly prone to financial bubbles -- huge, seemingly irreversible rises in the value of one sort of asset or another, followed by sudden and largely unforeseen plunges.

What makes bubbles so dangerous is that their consequences, when they burst, are wider, often more damaging, and certainly more unpredictable than those of ordinary downturns.

"We are more prone to bubbles than we used to be," said John H. Makin, a former senior Treasury official with several Republican administrations and now a scholar with the conservative American Enterprise Institute in Washington.

"The old-fashioned recession, where the consumer ran out of gas or there was an economic policy mistake, doesn't seem to occur much anymore," said Alice M. Rivlin, a former vice chair of the Federal Reserve and Clinton administration budget director. "As we've seen from recent events, bubbles seem to be playing a bigger role."

Economists such as Rivlin and Makin do not necessarily oppose traditional stimulus proposals.

"When there's a flood, I'm not against throwing in sandbags," Makin said. "It's not going to solve the problem. It's not going to reverse it. It might mitigate it."

But the overriding requirement, they say, is that economists and policymakers need to develop ways to identify potential bubbles, discourage them from growing, and limit the economic carnage if they do.

Analysts trace the economy's growing propensity to develop bubbles to an unusual chain of events. Since the early 1980s, increasingly effective Fed policymaking, coupled with financial innovations such as the expansion of credit cards, home-equity loans and exotic security derivatives, helped shrink large-scale fluctuations in the economy in what economists call the Great Moderation.

Inflation and unemployment fell. Growth of the gross domestic product and employment steadied.

In addition, technological advances and new management techniques such as just-in-time inventory practices all but removed the mismatches of supply and demand that prompted employers to shrink production and employment, periodically setting off downward spirals.

Also, policymakers abolished many of the financial regulations that had grown up after the Great Depression. And with many other countries growing more prosperous too after the Cold War, investment capital flowed into the United States, making funds available to borrow for almost any purpose.

This run of good news set off a near-two-decade bull market in U.S. stocks and allowed the nation's economy to boom as it hadn't since the 1960s. But it also prompted a new generation of financial engineers to forget the lessons of the past and replace old and diminishing risks with new and even larger ones.

The invention of sub-prime mortgages, which have been at the center of the current crisis, is just one example.

"We've had a lot of financial innovation over the last several decades, and it may be that some aspects of it have made the economy more prone to bubbles," said Douglas W. Elmendorf, a former Fed economist now with the centrist Brookings Institution in Washington.

"A lot of clever people thought they could make [big] bets and lay off the most serious risks on somebody else -- and they were wrong," said J. Bradford DeLong, a former Clinton administration Treasury official and a UC Berkeley economic historian.

This combination of factors has resulted in a series of bubbles that repeatedly played havoc with the economy. The run-up in value of mortgage-backed securities and houses, followed by their abrupt fall back to earth, are at the center of many of the economy's current woes.

Earlier, stocks in high-tech companies went through a boom and bust that helped bring on the recession of the early 2000s. Before that, a regional real- estate bubble, fueled in part by the savings-and-loan fiasco, is widely thought to have contributed to the recession of the early 1990s.

In focusing on identifying incipient bubbles and trying to prevent them, as suggested by Makin and Rivlin, the political and policy worlds will be making a substantial shift. Until now, the conventional wisdom has been that bubbles could not be identified except in hindsight and that policymakers should not try.

That view was given broad currency by former Federal Reserve Chairman Alan Greenspan as an explanation for the Fed's inaction during the 1990s stock boom. After tentatively suggesting in 1996 that stock prices were exhibiting "irrational exuberance," Greenspan opposed any effort to tamp down the market, saying that productivity was growing so rapidly that many of the old reasons for concern no longer applied.

But Greenspan's theory has become increasingly hard to maintain in the wake of what has happened in housing. The growth of the housing bubble is clear in a chart published by Yale economist Robert J. Shiller in 2006. It contains an index of U.S. housing prices going back to 1890. The chart, which set the 1890 benchmark at 100, showed that prices fell only about 30 index points during the Great Depression and rose only about 40 points during the giant postwar housing boom. In the decade after the late 1990s, however, the index jumped 100 points.

"If I were the Fed, I'd think twice about continuing to say we can't identify bubbles," Makin said. Given the threat now posed by sagging house prices, the sub-prime mess and a more general financial constriction, "we'd better work harder learning how to identify bubbles and preempt them."

One suggestion: an independent board similar to the Business Cycle Dating Committee, which decides when recessions occur, to investigate when the prices of key assets appear to be going off the charts and to issue public warnings.

"The group's job would be to put out an indicator of 'bubbleness' to tell us when prices look unsustainable," Rivlin said.

Some analysts argue that bubbles are simply the price of an innovative economy and one worth bearing, a case that House Financial Services Committee Chairman Barney Frank (D-Mass.) describes this way: "We're more prone to bubbles, but less prone to severe recessions."

The problem, as Frank is quick to point out, is that bursting bubbles have a nasty habit of getting out of hand.

Both the Fed and the Treasury have repeatedly underestimated the dimensions of the housing and sub-prime crises, announcing they were contained only to watch them reemerge and threaten a crippling financial freeze-up. The two agencies' efforts to come up with solutions have produced at best modest results.

The Treasury tried to orchestrate a privately financed fund of $100 billion to help exotic "special investment vehicles," for example. But the big banks that would have benefited found that almost no one would contribute, so the effort was dropped.

Meanwhile, the Fed's efforts to deal with liquidity problems failed to address more serious solvency problems tied to the rising probability of home-value losses exceeding $3 trillion.

In such circumstances, Frank said, the real solution -- with or without a stimulus -- is to try to prevent future bubbles by "reasonable re-regulation."

"We've done the innovation of the financial system, but we've never done the innovation of the financial regulations," he said. Operating largely unfettered by the government, the private sector's risk management has not spread or reduced risk.

It's a danger that Frank and others have warned about repeatedly in recent years, but they were largely ignored.

Frank is scheduled to deliver a speech on the subject Monday at Harvard. The title is "We Told You So."

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