Bubbles:
Surviving Until Next Time *
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We are in the painful crash phase of the largest U.S. housing bubble on record. Housing prices are rapidly declining from the unsustainable levels to which they had grown from 1997 to 2006. Runaway expectations of rising prices, coupled with low interest rates, brought the dangerous easing of traditionally conservative down-payment requirements--the old style capitalistic mechanism by which home buyers and bank lenders are both protected from unpredictable declines in the value of homes, or the capacity of home owners to make loan payments.

But our brutalized economy will survive the crash--after a scare and some scars.

This was not a stock market bubble. The economy was doing well, hurt by domestic prohibitions on oil exploration, but thriving marvelously on its engine of innovation and new technology, with rapid productivity growth.

Unlike the stock market bubble of the 1990s, which created revolutionary forms of dot-com, biochemical, computer-communication and knowledge-based wealth, this bubble was a housing-consumption binge based on inadequate equity by home owners, bank lenders, mortgage repackaging magicians and insurers. The house of cards has collapsed.

Everybody is looking for someone to blame; don't go there, the enemy is us.

With popular bipartisan support, Congress spent 70 years creating legislation designed to make it easier for people to own their own homes. Fannie Mae (nyse: FNM - news - people ) was a 1938 New Deal creation and became a government sponsored "private profit " enterprise (owned and operated by shareholders) in 1968. To give it some "competition," Freddie Mac (nyse: FRE - news - people ) was born in 1970. Both were exempt from state and local taxes, as well as Securities and Exchange Commission oversight, and implicitly believed by all to be ultimately protected by the U.S. Treasury.

Then came the bipartisan Tax Relief Act of 1997, allowing you and me to take a tax-free profit of up to $500,000, after a two-year holding period, by reselling to the next half-millionaire aspirant. (No other asset from factories and shares to patents enjoyed this capital gains free ride.) Then, under increasing top-down pressure from the Clinton administration, Fannie Mae expanded its mortgage loans to those of low and moderate income, while financial institutions...
vigorously pressed from the bottom up for more loans to subprime borrowers. (S. Holmes, NY Tmes, September 1999)

We did our best to do good for the poor, and failed. Poor and rich alike helped generate a king-sized Ponzi scheme, with no schemer in charge--it was you, me, our elected reps, financial magicians and government who were complicit in privatizing Fanny and Freddy profits but socializing their losses.

I believe this crash will end to the extent that the Treasury moves directly to recapitalize banking institutions. I favor doing so with direct purchases of new bonds, no more than five-year-term, convertible into non voting (by Treasury) shares at prices comfortably above the current share prices of individual banks, and exercisable only after a year or so. The idea is to provide immediate cash infusions, ample scope for private funds to flow into the recapitalization of banks, and at the same time allow the battered U.S. Treasury to recover a taxpayer return.

To the extent that our past folly requires us now to bail out investors, who imprudently depended on a continuing rise in home prices in order to be made whole, we will set the stage for the next housing bubble--the largest of them all. But it will not come until well after the current decline in housing prices has run its course and is no longer fresh in memory.

Exactly when is as unpredictable as when this one will bottom out.

Economists are not good at prediction, but we can tell pretty good stories after we see and think about big events--and do some econometrics. If it were otherwise we would be rich.

What I think is most likely after we recover from this housing/financial debacle is the return of capital flows into equities, particularly flows with a sharper focus on the exciting range of rapidly advancing new technologies where knowledge has exploded in spite of the housing binge. A bubble there will yield its traditional share of failures--nothing ventured, nothing gained--but it is sure to fuel an array of innovative experiments in managing new technologies. There will be breakthroughs that will create vast new increases in wealth: the ultimate source of human economic betterment.

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*Note: This is a slightly edited final version of the printed article that did not arrive in time for the publication deadline. Also, included here is a chart that could not be included with the final printed article. (VLS, October 23, 2008)