12

Bubbles Lead to Long-term Instability

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1. Introduction

Excessive liquidity has financed a series of bubbles in the last ten years. Central banks have not tried to prevent bubbles from ballooning but have raised interest rates once inflation exceeds the target or there is persistent overheating, thereby pricking the bubble. Moreover, central banks have added liquidity every time a bubble has burst and cut interest rates to offset the deflationary gap. By doing so, the central bank has prevented the necessary de-leveraging and has perpetuated the excessive liquidity thus sowing the seeds for the next bubble. This explains how successive bubbles have been created and subsequently pricked. The house bubble is a transformation of the internet bubble and the commodities bubble a transformation of the house bubble. The story keeps repeating but, in every cycle, liquidity increases.

In the long run this is an unstable situation as, in every business cycle, the liquidity in the system is further expanded and the new bubble is bigger than the previous one. At the peak of each cycle lower interest rates than before are sufficient to prick the bubble, but the resulting downturn is worse than before. Thus, US interest rates peaked at 6.5% in the early 2000s downturn, but peaked at 5.25% in the recent downturn. The current downturn is far worse than that of the early 2000s. In the current credit crisis the Fed has flooded the system with more liquidity than ever before and a new bubble in US Treasuries has emerged. Rising government bond yields will prick this bubble in the future as default risk premia, inflation risk premia and exchange rate risk premia increase because of the huge issuance of Treasuries necessary to cover the cost of the bailout of the financial system and/or because of monetization of the government debt. The burst of the Treasury bubble
will either prolong and deepen the current recession or will cause another recession later on.

Although a host of reasons may be responsible for this mess, the New Consensus Macroeconomics (NCM) or Neo-Wicksellian model (see Arestis, 2007), which forms the intellectual basis of the policies pursued by central banks, has certainly played a vital role, as it does not assign any importance to liquidity and therefore it is not capable of detecting the roots of the credit crisis and monitoring its developments. Arestis and Karakitsos (2008) have suggested an overhaul of the NCM model by endogenizing the natural interest rate and potential output, while Karakitsos (2009) has further expanded the model by including a wealth effect in consumption and explaining the constituent components of wealth – house wealth and equities – bringing to the fore the equity risk premium and credit risk. This chapter shows that such a model is capable of explaining the stylized facts of asset and debt deflation that characterize the current downturn. The inherent instability of the policies pursued by the Fed (i.e., injection of liquidity every time a bubble bursts) is demonstrated by simulating a highly leveraged version of this model. As the degree of leverage increases, the actions of the central bank lead to instability.

The chapter is organized as follows: section 2 explains the stylized facts of the last two asset-led business cycles and highlights the inadequacy of the NCM model in a credit crisis. It also points to the errors of monetary policy that aggravated the current downturn. Section 3 presents an overhaul of the NCM model. Section 4 analyses the dynamic effects of a credit crisis. Section 5 demonstrates the instability that a central bank causes if the economy is highly leveraged. Section 6 uses the model to explain the stylized facts of the last ten years, while Section 7 concludes and summarizes.

2. The stylized facts of the last two asset-led business cycles

The excessive liquidity\(^1\) that has financed three major bubbles in the last ten years (internet, house and commodities)\(^2\) and two minor ones (shipping and private equity) in terms of their impact on the economy has been created since the repeal of the Glass–Steagall Act in 1999 (see Arestis and Karakitsos, 2009). This Act was introduced in the 1930s, separating commercial banks from investment banks so that the former would be prohibited from speculating and taking excessive risks with the deposits of ordinary people. Investment banks, on the other hand,