



**Financial Crisis:
We have found the enemy and he is us
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1. Price Bubbles are not new

- Historical: Tulip Bulbs, 1737; South Sea Company Shares 1720; Many Financial Crises in 19th & 20th Century US and World
- Asset (Stock) Market Bubbles are easily created in Laboratory

2. Why Price Bubbles? What we have learned from laboratory stock trading where subjects earn real money paid in cash.

- Receive initial endowments of cash and shares.
- Given complete and accurate information on period by period fundamental (asset dividend value). Theoretically should not trade at prices other than fundamental.

3. Observe massive lab price bubbles that deviate from fundamental value. (Smith, Suchanek and Williams, *Econometrica*, 1988; Porter & Smith, *Applied Mathematical Finance*, 1994).

- Model explanation is based on hypothesis of two kinds of trading behavior:
 - (1) Fundamentalists who buy (sell) in proportion to discount (premium) on true value;
 - (2) Momentum traders who buy (sell) in proportion to percentage increase (decrease) in current prices
- Traders are not irrational given their expectations: but such expectations are not sustainable.
- Model makes qualitative predictions that have been correct. But timing of price turns cannot be precisely predicted, and believed by everybody. For then behavior would change, and the prediction would fail.

4. Current crisis. Hypotheses:

- Stemmed from Housing Bubble, not stock market
- Many past housing bubbles, but 1997 to ?...Mother of All.

5. Why?

- Government, through bipartisan consent of elected representatives and many past presidents, has long favored doing our very best to facilitate home ownership by those of modest means and income.
- To this explicit end, Fannie Mae was a 1938 New Deal creation, “privatized” in 1968; Freddie Mac was born in 1970; both were exempt from state and local taxes, SEC oversight, and implicitly believed by all to be ultimately protected by the US Treasury.
- Then in 1997 a strongly supported bipartisan Act under President Clinton exempted capital gains on the sale of a home from all taxes up to 1/2 million dollars. (Adding some perspective, the total value of all homes in the U.S. is equal to the total value of all public corporations in the U.S. Each is about 1/3 of all U.S. wealth.)
- This action created a huge incentive for investment to flow into the sale and building of homes, and to abandon the old time fiscally sound requirement of high equity down payments on long term loans to home buyers.
- Guess what? This action coupled with previous government actions, widely approved by all citizens, brought the private sector into the game of making money on home sales, mortgages, banks, insurance.
- But there was a Catch-22: The road to tax exempt riches could work only for as long as every home seller could find a buyer who would pay him more for his home than he paid for it. The original policy failed magnificently.
- Young people bought homes earlier than normal; existing home owners bought bigger ones or second and third homes. They were buying from their own future at rising prices.

On the next page you will see the three most recent housing bubbles and why I call the one that started in 1997 (thank you Republicans and Democrats) the Mother of All Housing Bubbles.

On the page following you will see the DJ Industrial Index Percent change 1975 to 2008 along with the three most recent House Bubbles.

Conclusions and What’s to be done?

