

Discussion

1. David Merrett

I would like to thank John Simon of the Reserve Bank of Australia for a very interesting paper about earlier episodes of asset-price bubbles in Australia. I know from experience how hard it is to gather the data needed for this type of research. The further we move from the present, the more fragmentary and anecdotal the evidence on asset prices becomes.

What is a ‘bubble’? John proposes a common sense view that we know a ‘bubble’ when we see one. They are events characterised by rapid rises and falls in asset prices over short time periods, generally within 12 months. Moreover, the break in prices occurs without any new information that signals a change in the underlying fundamentals. *Ergo*, market behaviour has been driven by speculation. New buyers enter the market only so long as they believe that prices will continue to rise. Once that expectation no longer holds the asset is dumped. John suggests that a number of environmental effects, either alone or in combination, may provoke ‘bubbles’. He identifies three: an easy availability of credit, new technology and an increase in company formation.

John reviews three Australian ‘bubbles’: the Melbourne land boom of the 1880s and early 1890s; the Poseidon bubble of 1969–1970; and the 1987 stock market bubble and the subsequent property market boom. I have few quarrels with the data John presents or his interpretation of each of these episodes, with the exception of an aside that the paucity of data about Melbourne’s land boom makes interpretation of that complex episode problematic. For the rest, there is insufficient substance in points of fine detail to fill my 10 minutes of discussion time.

Rather I shall concentrate on broader issues. John concludes his paper saying ‘bubbles’ matter, whatever their origins if they are big enough to ‘have significant consequences’ for policy-makers, especially central bankers. That’s why we are all here. An asset ‘bubble’ of significant proportion, residential property, may burst soon in this country. Will the landing be hard or soft? What will be the flow-on effects of a sudden collapse in property prices on household wealth and the balance sheets of those financial institutions whose lending has underwritten the boom? The dilemma for the authorities is that employing monetary policy to dampen the ‘bubble’ may have unwanted consequences for the rest of the economy.

In this context John’s paper is timely and important. His study is an exercise in early diagnosis, if we understand the conditions that create ‘bubbles’ we can better cure the disease. He looks for common patterns in three widely differing events, separated by more than a 100 years and that range from ‘bubbles’ in property – land, residential and commercial property, mining shares and equities more generally. I am not convinced that the episodes John examines provide a generic explanation of why ‘bubbles’ occur. The three pre- or co-conditions he identifies of a new technology, easy credit and company formation, play dissimilar roles in the various ‘bubbles’.

Moreover, John argues that there were major differences in the ‘consequences’ of the bursting of the ‘bubble’ on the real economy. My interpretation of his position is summarised in Table 1. It seems to me that each of the episodes has its own ‘story’ that is complicated and nuanced, and is grounded in temporal and institutional frameworks. The first property boom was set in motion by rapid population growth and the provision of urban infrastructure that allowed subdivision on the margins of Melbourne. It is not clear to me that the current property boom was precipitated by similar drivers. The discovery of a deposit of nickel, whose price was rising, would be expected to push up the price of shares in new nickel mines. Was there a similar piece of information that would have led investors to believe that corporate earnings and dividends would rise in the late 1980s?

Table 1: Comparison of Three ‘Bubbles’^(a)

	Melbourne land boom	Poseidon	1987 bull market	Property market
Technology	Yes	?	?	?
Expansion of credit	Yes	?	Yes	Yes
Optimism	Yes	Yes	Yes	?
Company formation	Yes	Yes	Yes	?
Fraud	Yes	Yes	Yes	?
Impact on real economy	Major	Trivial	Modest	?

(a) Adapted from Simon (this volume)

Can we construct a model of ‘bubbles’ that has predictive power about when and where they will appear? Hyman Minsky notwithstanding, I am not confident that we can. The underlying factors that John identifies are intuitively satisfying in that each has the ability to impact a shock that would shift demand and supply schedules. However, why do new technologies and/or changes in the availability in credit spark ‘bubbles’ in some markets while not in others? What’s the spark that starts the speculation in a particular class of asset? I suspect it will revolve around a unique set of factors whose interconnections can only be unraveled after the event. The broad influences John deploys in the paper are best seen as permissive rather than directly contributory.

Let me offer a somewhat different interpretation of the history of ‘bubbles’ in Australia. Rather than seeking similarities between episodes I want to stress the differences in the causation, frequency and impact of ‘bubbles’ over time. The differences result from the changing nature of the economy over the long term, particularly the changing size of financial and securities markets relative to the real economy. It is also important to recognise that access to information about investment opportunities, particularly for households, has become more widespread over time.

Australia was a frontier economy for the first 100 years of European settlement. High levels of uncertainty surrounded the future stream of earnings from resource-based industries whose capabilities were slowly discovered through experimentation. The growth of production fluctuated sharply around the trend as output was affected by fire, flood, drought and diseases to animals and plants, and a capricious geology whose promised riches often failed to materialise. Prices were volatile, reflecting short-term swings of world demand and supply. There were frequent ‘rushes’, in the literal sense of migrations of people, to acquire previously unused assets such as virgin pastures and minerals below ground or to acquire assets, such as stock, in anticipation of rising commodity prices. Moreover, high and irregular levels of immigration injected uncertainty into the value of residential property in the expanding capital cities.

This first century was characterised by frequent ‘bubbles’, with sharp spikes in asset prices. However, they occurred in a local rather than a colonial or national context. The participants in these speculative asset markets were generally unincorporated enterprises. There was, for the most part, no secondary market in claims. Lending institutions played little part in financing these transactions outside the pastoral industry. While ‘bubbles’ in assets in the pastoral industry spilled over into recession in New South Wales in the 1820s and 1840s, and the Victorian gold rush of the 1850s had wide economic consequences, the majority of the frequent ‘bubbles’ left no footprint. Australia was still a series of largely independent colonial economies.

The potential for ‘bubbles’ to have a wider impact strengthened dramatically from the 1880s. The financial system was broadened by an expansion in the number of banks, their greater geographic reach through the establishment of branch networks and by the growth of non-bank financial institutions. The ratio of the assets of all financial institutions to GDP rose from 55 per cent in 1881 to 115 percent in 1891. The growth of credit shifted the demand schedule for all manner of assets to the right, not just Melbourne’s land and property. Though still a small minority, many businesses that owned and traded in real estate, pastoral land and mining leases had listed on the emerging stock exchanges. A market in secondary claims encouraged more people to participate in the speculation. The market value of securities listed on the Stock Exchange of Melbourne rose from 18 per cent of national GDP in 1884 to 31 per cent in 1889.

The rapid growth in credit fuelled the Melbourne ‘bubble’. The growth of the share market, comprised of more listed companies, and with higher daily turnover was another important contributory factor. Asset prices were marked to market on a daily basis and reported in the press. The gains of holding securities were there for all to see. Transaction costs of trading financial securities were, as John noted, lower than dealing in real property or other physical assets. The market looked relatively safe, risk could be diversified and you could cash out in a liquid market. Market-makers were important catalysts. Company promoters and share brokers assured investors and clients that this game of pass-the-parcel would never end.

The expanded financial and securities markets leveraged the ‘bubble’ going up and coming down. There was a new dimension to the end of a ‘bubble’, a secondary

impact as the financial institutions struggled as the customers' speculations turned to losses and defaults. The route between the breaking of the land boom in 1889 and the banking collapses of 1893 is long and tortuous, but there is a strong causal link. The liquidations and reconstructions of many Australian banks depressed the real economy for many years. It should be remembered that many British speculators, investors and bank deposit holders shouldered losses as well as the locals.

The next 100 years provided fewer opportunities for asset 'bubbles' on the scale of the Melbourne land boom. Many of the new technologies in energy, transport and communication that might have excited speculation were brought to market by the public rather than the private sector. The closing of the farming and pastoral frontiers lessened the opportunity for local 'bubbles' associated with the rush to capture newly available resources. Mining, on the other hand, kept up a flow of discoveries of new fields, particularly in the 1890s, 1930s and 1960s, many of which were associated with a traditional 'rush' to acquire shares before the mine or field's reserves were proven. There was widespread speculation in the subdivision of land in Sydney's suburbs through most of the 1920s but it never reached the heights of Melbourne 40 years earlier.

The key reason would seem to have been the modest expansion of credit for a very long time after the bank crashes of the 1890s. A chastened banking system behaved very conservatively, while many of the non-bank financial institutions that had underwritten speculation in the 1880s had perished. The ratio of the assets of financial institutions to GDP rose modestly from 86 per cent in 1921 to 102 per cent in 1929. Depression, war and direct controls over the banking system under the 1945 legislation checked the growth of credit relative to GDP. In 1971, the ratio of the assets of financial institutions to GDP was 102 per cent. In retrospect, the 1880s was a decade of expansion and innovation in the financial system that was severely checked. The Australian financial system was still remarkably immature into the 1960s. We need to remind ourselves that the vast majority of Australian households did not have accounts with commercial banks until after World War II. Access to personal finance dates from the 1950s.

Conditions for a 'perfect storm' were brewing through the 1980s and 1990s. Once again, there was a sea change in the strength of the permissive factors that played such a decisive part in the 1880s. There was a massive increase in credit, especially after financial deregulation. The crude measure of the assets of financial institutions, excluding the central bank, to GDP rose from 107 per cent in 1981 to 160 per cent by 1987. Since World War II more and more firms incorporated and listed on stock exchanges. Households and financial institutions, particularly life offices and pension funds, acquired shares as part of their portfolios. The ratio of the market value of listed equities to GDP rose from 22 per cent in 1976/77 to 70 per cent in 1986/87. Bull markets in other countries provided a strong demonstration effect to local investors. Firms took advantage of favourable sentiment to issue fresh capital.

An important new factor has impinged on the current property boom, public policy. The combination of a shift towards self-funded retirement, compulsory superannuation contributions swelling the coffers of funds managers, first-home-buyer

grants and tax laws that inflate the return on property relative to other investments add materially to its strength.

If this ‘bubble’ is of the same order of magnitude as the Melbourne land boom of the 1880s, will its end be as catastrophic? I suspect that it will not, largely because of policy instruments available today. Falling asset prices will reduce household balance sheet totals and net wealth. How many households are so heavily geared that a drop in price will result in bankruptcy? Will the reduction in wealth spill over into lower consumption expenditures that will feed through to the real economy? If that were to happen the weapons of both monetary and fiscal policy can be deployed. Moreover, there was no lender of last resort facility in the earlier episode. Contagion spread across fringe financial institutions and finally to the banks. Nearly all of those that ‘suspended’ and reconstructed were solvent. The current regulatory regime enforces higher prudential standards than were exhibited in the late 19th century. Further, the Reserve Bank can act as a lender of last resort if that is necessary.

My broad point is that as the Australian economy developed over time, the causes and consequences of the ‘bubbles’ occurring within it have altered as well.

2. General Discussion

A number of participants concurred with David Merrett’s view that changes in the economy and the financial sector between the events presented by John Simon made it difficult to make generalisations about the nature of bubbles and their impact on the real economy. Several participants commented on particular changes that have occurred which might result in asset-price bubbles today having a smaller impact than they would have had in the past. One participant highlighted that a significant change that had occurred since the 1880s Melbourne land price boom was the move to a flexible exchange rate regime, which allowed monetary policy to react to domestic imbalances. Another participant noted that any policy response to an asset-price misalignment today is likely to be considerably different to that which had occurred in history, as policy-makers have learnt from their past experiences – the tightening of monetary policy by the Federal Reserve Board during the Great Depression in the United States was used as an example. Others highlighted improvements in prudential regulation and supervision, and one participant suggested that the Australian banks had considerably changed their practices after the experience of the early 1990s and the fallout from the last commercial property boom. One possibly offsetting change that was highlighted by Merrett was the greater exposure of households to financial markets, though one participant noted that, while this was undoubtedly true, households today also have considerably more information available to them than previously.

Several participants wondered if the term ‘bubble’ was something of a misnomer. They suggested that an asset-price bubble need not be associated with a rise and fall in prices, as Simon focused upon in his definition. For example, it was suggested that if the fundamental value of an asset collapsed, but its market price remained

unchanged, then this misalignment could be construed as a bubble. However, other participants noted that this sequence would not engender the same market dynamics and herding as would the standard increase in asset prices normally associated with 'bubbles'. In light of this discussion, some participants considered that the term 'asset-price misalignment' may be more appropriate than the term 'bubble'. One participant suggested that these asset-price misalignments could occur as people mistake a shift in the level of fundamentals, such as potential output, for a shift in the growth rate, leading them to be overly optimistic.

There was some debate about whether the real effects of the 1987 bubble in share prices were perhaps more substantial than Merrett had suggested. It was argued by one participant that the subsequent commercial office property-price bubble did have substantial real effects, such as overinvestment. Merrett responded that this was the case, but contended that the effects were small relative to those in the 1890s.

A number of conference participants commented that it was important to consider asset prices in the context of supply and demand. In particular, it was conjectured that the price of assets whose supply is inelastic (unresponsive) with respect to their price may be more prone to misalignment. The property market was used as an example of where this may be the case. Secondly, it was argued that inelastic supply may also mean that higher valuations compared to other assets may be appropriate, as the price may embody some scarcity value. Another participant questioned whether this meant that supply-side policies may be more appropriate in dealing with asset-price misalignments.

There was some discussion about whether property-price bubbles are different to those in the equity market. It was observed that property-price bubbles appear to be more protracted and have larger real effects. The latter was thought to be due to the higher amount of leverage that is typical in property relative to in equity markets.

Some of the discussion focussed upon the role of global factors in the asset-price misalignments examined by Simon. These factors included the role of immigration in the 1880s Melbourne land price bubble and strong global commodity prices in the Poseidon episode. The entry of foreign banks after financial deregulation and the ensuing strong credit growth, as well as strong commercial property prices world-wide after the collapse of the share-price bubble, were also highlighted as global factors contributing to the 1980s commercial property-price bubble in Australia.