Asset Bubbles—Is It a Mad, Mad World?

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[A]ll too often in economics . . . we are faced with competing theories that can seemingly account for the same facts and we have no way of conducting decisive experiments that can distinguish between them.

--Marcus H. Miller, *discussing asset bubble theories.*

Commodity Bubbles

- There is a perception, held by many, that we are in the midst of a commodity bubble.
- A general theory advanced as a cause of this seems to be:
  - Commodities have become an asset class for investment.
  - An influx of investment into futures markets must increase the demand for futures contracts and/or the commodities underlying them.
  - This creates upward pressure on prices, not justified by fundamental market conditions.

Asset Bubbles

- Defining a bubble.
  - Price rises quickly and then fall precipitously.
    - Only known after the fact (not very useful).
  - Price departs from fundamental value (there is a speculative component to prices).
    - In theory could be higher (inflated) or lower (depressed)
- Asset bubbles are thought to:
  - Distort the price discovery function of futures markets
  - Cause misallocation of resources
- Asset bubbles and futures markets are not well studied.

Asset Bubble Theories

- Existence of an asset bubble implies something has gone wrong with price discovery in the affected market.
- There are various bubble models:
  - Greater Fool Theory (Can always sell it to someone else for more)
  - Herding (Investors buy or sell in direction of market trend)
  - Liquidity (Too much money chasing too few assets)
    - Commodities as an Asset class
    - Credit
  - Some firmly believe that there are no bubbles

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What is a Regulator to Do?

- Most debate on bubble policy has been in relation to the Fed and monetary policy.
- The theory is raising interest rates contains liquidity and pops the asset bubble.
- While there is a great deal written about bubbles and monetary policy, other interventions are not discussed much.

Making the Call

- Decision Tree (based on framework by Glenn Rudebusch, Fed Reserve Bank of New York)
  - Can policy makers identify a bubble?
  - Will fallout from a bubble be significant and hard to rectify after the fact?
  - What tools can deflate the bubble (In the Fed’s case, is monetary policy the best tool to deflate the bubble)?
- Sorting through these questions requires a great deal of knowledge about markets that we may or may not have.

Controversy with Bubble Popping

- There is still a great deal of debate about whether the Fed should pursue a policy of trying to manage bubbles or not.
- Concerns that have been raised by people such as Federal Reserve Chairman Bernanke are:
  - Given there are no generally accepted criteria, who determines when there is a bubble and what is causing it?
  - Monetary policy is a very blunt tool that can cause wide ranging collateral damage.

CFTC Bubble Options

- The CFTC faces different policy options than the Federal Reserve.
- Options suggested have been:
  - Raising margin requirements for speculators
  - Position Limits
  - Limiting market participation through defining acceptable hedging practices
- Questions associated with these options:
  - Can we accurately identify a commodity bubble?
  - Is there an objective way to determine the true value of a commodity?
  - Will these policy options effectively address a potential speculative component to commodity prices?
  - Is there a potential for detrimental impacts to markets?
  - Might some of these proposals actually lead to bubbles, rather than prevent them?

Questions for the AAC

- Are members concerned that there might be a commodity bubble?
- What further research could the CFTC do to identify or rule out a speculative component to prices?
- Is there a role for the CFTC in identifying and managing commodity bubbles and what research could facilitate this?
- What further research can help in understanding the potential impacts of different classes of investors?