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Rethinking Housing Bubbles
The Role of Household and Bank Balance Sheets in Modeling Economic Cycles
Steven D. Gjerstad, Chapman University, California
Vernon L. Smith, Chapman University, California
Cambridge, MA: Cambridge University Press
May 2014

Although Steven Gjerstad and Vernon Smith have published before on this topic in the Wall Street Journal and elsewhere, *Rethinking Housing Bubbles* is the most comprehensive development of their ideas to date. The book offers many compelling insights, but the thesis could be summarized as follows: 'the business cycle is a misnomer that should be changed to the housing cycle'. The authors build evidence for this claim throughout the book, but make the point particularly well in Chapter 5 when they analyze every recession in the United States of America between the Great Depression and Great Recession. I believe the authors' analysis is valid and presents new interpretations that deserve further investigation.

The book begins with a brief review of research on experimental economics, for which Dr. Smith won the Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel in 2002. The review emphasizes two ideas. One, people are good at finding the theoretical equilibrium price for consumable goods. Two, people are bad at finding equilibrium with capital goods; in other words, we are prone to creating bubbles. The existence of bubbles in experiments has an interesting corollary: as experiment-participants repeatedly experience a complete cycle of boom/bust, they get better at avoiding bubbles in the future. These results clearly set the stage for the book since housing is generally the largest single capital asset that a person will own over their life and, thus, plays a critical role in macroeconomic cycles.

The book analyzes modern economic history in several different and effective ways. The authors begin with a detailed review of the statistical properties of the Great Recession in Chapter 3 and the Great Depression in Chapter 4. Both chapters do not present a mainstream view, but they are well reasoned and convincing. As I mentioned above, the authors describe a general cycle for housing and monetary policy in Chapter 5 as follows (pg. 144). Stage 1, a prior recession ends, housing begins to expand, and inflation is low. Stage 2, housing growth slows and inflation rises. Stage 3, the Federal Reserve Open Market Committee raises interest rates to fight inflation and inadvertently accelerates a downturn in housing that causes the next recession. In this story, the Fed targets the symptom (inflation, which lags) rather than the cause (housing, which leads) and sometimes accentuates economic cycles to the up- and down-side. This general cycle for housing and monetary policy is what leads me to suggest re-naming the business cycle as the housing cycle. It is certainly a controversial idea, but the authors carefully refine the idea in subsequent chapters using a variety of types of economic data.

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In my opinion, a major strength of this book is the methodology. Particularly, the ability to combine different types of historical records to create economic insight. The authors use time series data and political events to strike a balance between statistical and economic significance throughout the book. They even use public statements of central bankers to make inference about the efficacy of the bankers' intellectual framework: the most striking moment for me in this regard occurred when the authors use three different versions of the word 'to know' in German to suggest that Bernanke knew what to do in the midst of the Global Financial Crisis in September 2008, but did not know how to do it (pg. 213). I hope that this book provides a positive example of what Austrian Economics may yet become, if it is able to make better use of macroeconomic statistics and retain its critical character.

A possible weakness of this book is also the methodology. The authors seem to use a story-telling approach where they develop results and interpretations based on supposed patterns in the data. The manner in which statistical evidence is analyzed, in particular, may have insufficient rigour for contemporary economics. Critics may claim that a creative researcher can find evidence to support any claim using such an informal approach, which casts doubt over the entire book. One solution may be to increase the formality of the statistical analysis and hopefully remove the influence of the researcher in the empirical settings. Another solution may be to demand a formal, mathematical model to structure the theoretical ideas developed in the book.

My assessment is that the strengths of this book outweigh the weaknesses. The book uses different types of data to great effect: the authors document striking parallels between business practices that appear particularly at the time of the Great Depression and Great Recession; show that certain stylized facts have strong regularity across all recessions within the USA between the Great Depression and Great Recession; and even show regularity between the Great Depression, Great Recession, and several similar events that happened around the world. This method of analysis is inspiring for me because it shows that economists can use multiple types of data to gain analytic traction. The method produces new insight into the crucial role of housing in economic cycles and these results lead the careful reader to reflect on the complexity of the economic dimensions of human society.