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Bubbles, Quantities and Short Sales

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Remark on "What Happens Next?"

Good afternoon and thanks to Larry Bernstein for hosting a series of superb "What Happens Next" discussions over the last several months.

Events surrounding GameStop and Robinhood extend well beyond the immediate stories and headlines. They signal future issues that financial market participants are destined to confront and regulators are eager to confront.

There are big stories here, right? They stretch from financial market manias to regulatory policy to new technologies to the struggles between good and bad and the struggles between the big and little.

Based on these many fascinating vectors, a team of seven experts from the Center for Financial Stability (CFS) wrote a multidisciplinary paper on Robinhood and GameStop.[1] The paper stretches from finance to law to technology to education to policy recommendations.

Today, I will focus briefly on two issues

- **First, broad implications for financial markets … it is a bubble… and why… and**
- **Second, public policy, regulatory risks, and what to do.**

First, financial bubbles are flourishing. The GameStop / Robinhood saga simply adds further evidence to this perspective. **Quite simply, there would be no GameStop story without retail momentum traders. And, there would be no retail momentum traders without easy or near free money.**

The fundamental underpinnings to this facet of the story are not new, right. It is a combination of easy money and a new technology. Charles Kindleberger and Bob Aliber's famous "Manias, Panics, and Crashes" has an entire chapter devoted to "Fueling the Flames: Monetary Expansion." In seven editions, this chapter has changed very little over the years. The only real substantial change is Bob's emphasis on 'credit' in addition to money.[2]

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[1] Goodman, Lawrence, Steven Lofchie, Robin L. Lumsdaine, John D. Feldmann, Diane Glossman, Jack Malvey and Yubo Wang, Robinhood and GameStop: Essential issues and next steps for regulators and investors, Center for Financial Stability, February 4, 2021 - http://www.centerforfinancialstability.org/research/GME_Robinhood_020421.pdf.

[2] Aliber, Robert Z. and Charles P. Kindleberger, Manias, Panics, and Crashes: A History of Financial Crises, 7th Edition, Palgrave Macmillan, 2015.

So, where are we today?

Today, the risk-free cost of credit is near zero and central bank liquidity injections are massive. For instance, the cumulative injection of base money by the Federal reserve in the last 13 years is 600%. This dwarfs anything witnessed since the founding of the Fed. In fact, the cumulative expansion is 200% more than what was needed to rescue the economy from a great depression and to fight a world war ending in 1945.

So, there is a lot of free money sloshing around for day traders and momentum investors to fuel their activities.

For investors and officials, we need to recognize that it's the quantities that matter. Quantities are fueling speculative retail behavior, equity indexes, FX rates, and credit markets. We are no longer in an interest-rate world.

At CFS, we have developed and studied a range of quantities that measure liabilities in the financial system – under the leadership of CFS Director of Advances in Monetary and Financial Measurement, Professor William A. Barnett.[3] These measures have been helpful at charting market moves and economic behavior patterns.

Here, base money injections have (and will continue) to drive asset prices. But, now, we are beginning to see seepage of these policies into the economy and goods prices. Our broadest measure of money (CFS Divisia M4) has grown on average by 22% y/y since April '20 and most recently at 29%... versus 3.4% on average since 2008.[4]

This matters as a sustained move toward higher inflation could mark the turning point in this seemingly endless bubble that has been so nicely illustrated by the recent Robinhood and GameStop story.

So, what are the regulators do?

To be sure, regulation is essential – especially regulation that creates incentives for actors to behave prudently. Yet, often after financial crises or episodes of discomfort, the risk of regulatory overreach is high. Many come swooping in after-the-fact to explain what happened and create constructs designed to prevent the reoccurrence of previous problems.

[3] Barnett, William A., "Getting It Wrong: How Faulty Monetary Statistics Undermine the Fed, the Financial System, and the Economy," MIT Press, 2012 – see http://www.centerforfinancialstability.org/getting_wrong.php.
[4] See http://www.centerforfinancialstability.org/amfm_data.php.

The call for action today is strong. Ahead of a Hearing this Thursday, Chair of the House Financial Services Committee, Maxine Waters is using terms such as "predatory short selling," "vulture strategies," and "unethical conduct."[5]

The case of short selling is especially interesting. Most economists agree, short sellers are not necessarily the enemy but are often the friends of retail investors. Firms that engage in short selling have an incentive to uncover and or disclose fraud at an issuer… and those firms bear heavy risks … as prices can rise without limit and short-sellers can lose an unlimited amount. Regulatory action that drives them from the market, can be expected to have a materially adverse effect on the incentive to gather negative information, such as the kind that can be exposed as fraud, and limit two-way flow.

The deepest of ironies is that not so long ago, after the Global Financial Crisis, the big heroes were "The Big Shorts" or short sellers.[6]

So, regulators should thoughtfully ask and answer questions regarding the lessons from GameStop and Robinhood for financial stability.

Many of these questions are posed and answered in our paper. I will conclude with a few:[7]

- **Are short sellers the real problem?**
- **Can new technologies improve both surveillance and settlement times?**
- **What are the risks to financial stability?**
- **How did the system and plumbing perform?**
- **Most importantly, how is abundant monetary liquidity impacting regulated markets and institutions? In fact, since the release of our paper, steps are already moving forward here.**

[5] "Following Recent Market Instability, Waters Announces Hearing on Short Selling, Online Trading Platforms, U.S. House Committee on Financial Services," January 28, 2021.
[6] Lofchie, Steven, Kyle DeYoung, Conor Almquist, and Sebastian Souchet, GameStop: Regulators Should Focus Less on "Solving the Problem"; More on "Improving the Situation," The Cadwaladar Cabinet, February 16, 2021.
[7] Two are added from the discussion that followed.