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Short-squeeze bubbles

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Short selling is typically associated with lowering stock prices. This paper argues that the opposite might happen as well. Short selling might give rise to bubbles that would otherwise not be possible.

It is crucial for the argument that short selling, in practice, is not the same as issuing an asset and taking a negative position. It entails a commitment to buy the stock later on. By raising the stock's future demand, short selling might allow for a path of ever-increasing prices and sustain a bubble.

Several features of our model resemble the short-squeeze episodes of early 2021 and, in particular, the case of GameStop. Initially, the stock price is above its fundamental value. Buyers hope prices will keep rising for reasons unrelated to the company's valuation. Short-sellers hope the bubble will burst. Eventually, the latter capitulate. The ensuing short squeeze is fueled by short-sellers covering their positions, and the stock price skyrockets.

Bubbles of this kind require coordination among agents that is difficult to achieve -- at least if regulators can prevent agents from orchestrating a short squeeze. It is, however, easier for regulators to discipline Wall Street financial institutions than to oversee the actions of individual investors connected through social media. Trading by retail investors is booming. Short selling, usually associated with curbing excesses, might turn into a source of instability more often.