Bubbles, Crashes, and Economic Growth: Theory and Evidence

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We analyze the ups and downs in economic growth in recent decades by constructing a model with recurrent bubbles, crashes, and endogenous growth. Once realized, bubbles crowd in investment and stimulate economic growth, but expectation about future bubbles crowds out investment and reduces economic growth. We identify bubbly episodes by estimating the model using the U.S. data. Counterfactual simulations suggest that the IT and housing bubbles not only caused economic booms but also lifted U.S. GDP by almost 2 percentage points permanently, but the economy could have grown even faster if people had believed that asset bubbles would never arise.