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A Short History of Booms, Bubbles, and Busts

The first documented major boom–bubble–bust cycle was the Holland tulip craze that we already described in the Introduction to this book. The next section of this book presents a review of several of the important boom–bubble–bust cycles that followed from the eighteenth through the twenty-first centuries. We begin with two spectacular cycles from the eighteenth century, and then move on to the USA in the twentieth century.

In *The Great Crash*, John Kenneth Galbraith (JKG) briefly recounted some of the history of bubbles and crashes in the USA:

In the United States in the nineteenth century, there was a speculative splurge every twenty or thirty years. This was already a tradition, for the colonies... had experimented at no slight cost with currency issues that had no visible backing. They did well until it was observed that there was nothing there.

The American Revolution was paid for with Continental notes, giving permanence to the phrase “not worth a Continental.” In the years following the war of 1812–14, there was a major real estate boom; in the 1830s came wild speculation in canal and turnpike investment.... This came powerfully to an end in 1837. In the 1850s came another boom and collapse, in which a New England bank closed down with \$ 500,000 in notes outstanding and assets to cover them of \$ 86.48. After the Civil War came the railroad boom and a particularly painful collapse in 1873. Another boom came to an equally dramatic end in 1907.

These are only a few of the many cycles of excess in investing in the USA prior to the modern era. Bordo¹ and Wood² provide histories of booms and busts in the USA and the UK. They documented more than 20 crashes in the past two centuries. An International Monetary Fund (IMF) report³ identified 13 stock market bubble-crash sequences from 1800 to 1940, with peak-to-trough drops ranging from 16.4 to 66.5 %.

¹ Bordo (2003).

² Wood (1999).

³ World Economic Outlook, IMF, April, 2003 <http://www.imf.org/external/pubs/ft/weo/2003/01/pdf/chapter2.pdf>.

The rich tradition of booms and busts, established early in the history of the USA, was further propagated in the twentieth and twenty-first centuries, as will be discussed in the ensuing sections.

Then, we provide a brief review of a few recent Asian bubbles. Finally, we provide a brief discussion of prospects for the next bubble.

2.1 The New World

In the early 1700s, an intrepid entrepreneur (John Law) developed the foundations of modern bubbles with two promotions, the South Seas venture in England and the Mississippi Company in France. Like most bubbles that followed over the next 300 years, there was actually a genuine basis and rationale for believing that a great new opportunity was at hand. The opening up and settlement of the New World seemed to offer a vast source of raw materials and products, as well as a large potential market for European products. This was not entirely unlike the advent of the automobile and widespread electrification in the 1920s or the introduction of the Internet in the 1990s. Bubbles are usually based initially on seemingly sound and rational future prospects. Where bubbles often go wrong is in assuming that these prospects can be easily tapped in the immediacy of time. As enthusiasm builds, investors lose sight of the realities of the prospect and focus only on trading paper for profit. John Law was a great financial innovator. He was the first to espouse the use of large-scale credit and printed money as a replacement for hard currency. He was the original Flim-Flam man (no disrespect meant for George C. Scott). If he were alive today, he would likely be made director of the US Federal Reserve System. Many of the corporate manipulators of our time (Milken, Keating, Lay, Rigas, etc.) would have been proud to have known John Law and would have paid great homage to him as the founder of their profession.

2.1.1 South Seas Bubble

In late 1719, John Law circulated his treatise on economics entitled *Money and Trade Considered*. As Smith discussed, the two central ideas in this work were: (1) credit, when circulated, acts as if it were conventional currency, and (2) commercial activity is stimulated by the money supply.⁴

Mr. Law applied these theories to the South Sea Company in Great Britain. The South Sea Company was created to “take over” responsibility for British government debt in exchange for the exclusive right to engage in trade with

⁴ Smith (2004).

Spanish America. As would be the case with the subsequent Mississippi Company, holders of government bonds, which traded at significant discounts due to the precarious financial condition of the government, could use their depreciated bonds at face value to acquire South Sea shares. The company agreed to accept reduced interest payments from the government on bonds it received in exchange for its newly issued shares. As in the case of the subsequent Mississippi Company, everyone seemed to benefit; “the government was able to reduce the interest payments on the public debt, bondholders would receive [what seemed to be] full value for their bonds, and the new company itself would presumably be able to reap large profits from future trade with the Americas.”

The press was enthusiastic. Wild claims were made for the demand for luxury merchandise in the New World, and “frequent references were made to large deposits of precious minerals in South America.” It was widely assumed that the South Sea Company could achieve great profitability from trading with Spanish colonies in the New World.

However, as Smith (2004) observed,

Some observers were skeptical, noting that at the time the South Sea Company was formed, the Spanish government forbade foreign nationals from trading with its colonies, a policy that seemed unlikely to change.

In its early years, the South Sea Company did not do well; the only concession the Spanish allowed was the right to engage in the slave trade. But in 1720, the company engaged in a number of practices that started a speculative binge. It spread extravagant rumors of the value of its potential trade in the New World. It loaned shares to highly placed officials in the government and bought them back when share prices rose, generating profit for politicians based on no investment. Meanwhile, the South Sea Company acquired an aura of legitimacy on the claim that all the top government officials had “invested” in the company. One website claims that 462 members of the House of Commons and 112 Peers were involved with the company, and that King George I and his two mistresses “were heavily involved in the South Sea Company.” The stock price increased eight-fold from January to June 1720. As Wikipedia said,

Its success caused a country-wide frenzy as citizens of all stripes—from peasants to lords—developed a feverish interest in investing; in South Seas primarily, but in stocks generally. Among the many companies, more or less legitimate, to go public in 1720 is—famously—one that advertised itself as “a company for carrying out an undertaking of great advantage, but nobody to know what it is.”

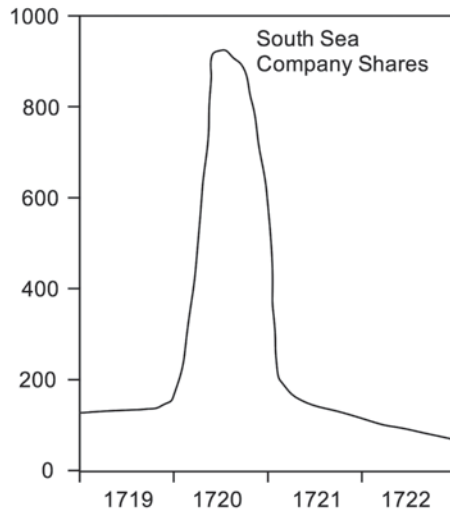


Fig. 2.1 South Sea Company share prices

A number of other joint-stock companies then joined the market, making usually fraudulent claims about other foreign ventures or bizarre schemes, and were nicknamed “bubbles.”

The South Seas Company held a charter providing exclusive access to all of Middle and South America. However, the areas in question were Spanish colonies, and Great Britain was then at war with Spain. Even once a peace treaty had been signed, relations between the two countries were not good. The... South Sea Company was able to obtain [the right] to send only one ship per year to Spain’s American Colonies.

The bubble popped at the end of the summer of 1720, and the stock price dropped by a factor of 8 in September. A number of people around the country lost all their money and “the gullible mob whose innate greed had lain behind this mass hysteria for wealth, demanded vengeance. The South Sea Company Directors were arrested and their estates forfeited.”

Jiménez⁵ provided Fig. 2.1 (originally drawn by Elliott Wave International).

2.1.2 John Law’s Mississippi Company

The originator of the South Seas bubble in England got into trouble by killing his opponent in a duel and had to escape to France, where he promptly began

⁵ Jiménez (2011).

a similar scheme called the “Mississippi Company.” Smith⁶ provided an excellent description of John Law’s Mississippi Company.

John Law founded the Mississippi Company and acquired from the French government the exclusive right to trade with the French Colony of Louisiana. This was coupled to a plan to reduce the French government’s payments on its debt.

John Law used the same basic strategy for the Mississippi Company as for the South Seas Company. The state of the French government’s economy was very poor and French government bonds traded at a large discount. Law worked out a deal with the French government whereby his Mississippi Company would offer to trade shares in the company to the public for the French government bonds at par, and he would agree to accept lower interest payments from the government on the bonds he acquired. As in the case of the South Seas Company, this seemed to benefit the French government, the bondholders and the Company. However, as we perceive in retrospect, the bondholders were trading discounted paper with tangible value for par value paper backed only by dreams and speculations.

As in the South Seas Company, initial public response was lukewarm, so he added a number of new features, such as exclusive rights to “raise tobacco (which was rapidly becoming popular in France) as well as the right to trade in slaves and other products from the French colony of Senegal.” All of this was paid for with newly issued shares:

In order to sell the new stock, Law aggressively hyped the company’s prospects in a promotional blitz that resembled a modern public relations campaign.

He continued a wide range of financial schemes and the stock rose by more than a factor of 10 in a buying frenzy of the public.

Smith described the buying frenzy of luxury items that resulted from this early stock bubble that produced a “stock market-induced wealth effect—a change in personal consumption patterns arising from dramatic moves in stock prices.”

During the same time period that the South Seas bubble expanded and popped, the Mississippi Company went through the same type of cycle—a runaway bubble followed by a popped bubble. John Law’s involvement with the French government and his rampant generation of credit (he even lent government money to people to purchase company shares) led to a severe inflation.

⁶ Smith (2004).

2.2 Florida Land Boom of the 1920s

2.2.1 The Rise

In 1931, Fredrick Lewis Allen⁷ wrote the oft-quoted classic book *Only Yesterday* that described the era of the 1920s with great insight and perception. One of the major financial events of the 1920s was the Florida land boom, and Allen discussed this in detail. As Allen described it, the boom built up over several years, but reached a frenzy by 1925, when:

Miami had become one frenzied real-estate exchange with 2,000 real-estate offices and 25,000 agents marketing house-lots or acreage.... The city fathers had been forced to pass an ordinance forbidding the sale of property in the street, or even the showing of a map, to prevent inordinate traffic congestion.

People flooded into Florida to buy and sell land:

Hotels were overcrowded. People were sleeping wherever they could lay their heads, in station waiting rooms or in automobiles. The railroads had been forced to place an embargo on imperishable freight in order to avert the danger of famine; building materials were now being imported by water and the harbor bristled with shipping. Fresh vegetables were a rarity, the public utilities of the city were trying desperately to meet the suddenly multiplied demand for electricity and gas and telephone service, and there were recurrent shortages of ice.

By 1925 they were buying anything, anywhere, so long as it was in Florida. One had only to announce a new development, be it honest or fraudulent, be it on the Atlantic Ocean or deep in the wasteland of the interior, to set people scrambling for house lots.... The stories of prodigious profits made in Florida land were sufficient bait.⁸

Allen provided many examples of huge increases in the prices of lots. These stories were multiplied and spread, adding fuel to the fire. The standard joke at the time was: “a native saying to a visitor, ‘want to buy a lot?’ and the visitor at once replied: ‘Sold’.”

Lots were bought from blueprints. Subdivisions were drawn up, and advertisements described them. “Binders” were made with a check for 10% down payment. (Note that during the subprime real estate boom of 2002–2007, many properties were sold for no money down, and some were sold on the basis that no payments of principal need be made for the first few years. Thus,

⁷ Allen (1931).

⁸ Allen (1931).

the 1920s Florida land boom was in some ways conservative compared to the twenty-first-century real estate boom.)

Plans were laid out for new hotels, apartment houses, and casinos. Allen described a sight at the height of the boom where a large vacant lot was almost completely covered with bathtubs in crates that had been there for some time. The tubs were intended for apartment buildings but the freight embargo had held up the remainder of the contractor's building material and after the bathtubs arrived.

Allen also described the advertisements of the time as resounding with "slogans and hyperboles of boundless confidence." The *Miami Daily News* printed an issue of 504 pages (mainly advertisements) one day in the summer of 1925.

By the height of the land boom of the 1920s, a single piece of land was changing hands as many as six times a day. "Binder Boys" sold land for a small down payment, the understanding being that the land would probably sell at a higher price before the next payment came due. There always seemed to be another buyer hoping to jump into the market, causing the prices to skyrocket further.

2.2.2 The Fall

The Florida land boom began to collapse in the spring and summer of 1926. People who held binders were defaulting on their payments. Many of those with paper profits found that the properties they owned were preceded by a series of purchases and sales, all at 10 % down, and as many of these defaulted, the only options were to either hold onto the land at a great loss or default. The land was often burdened with taxes and assessments that amounted to more than the cash received for it, and much of the land was blighted with a partly constructed development. As the deflation expanded, two hurricanes added the finishing touch to the bursting bubble. The hurricanes left 400 people dead, 6300 injured, and 50,000 homeless.

According to a source quoted by Allen, by 1927, the approach to Miami by road was littered with dead subdivisions:

...their pompous names half-obliterated on crumbling stucco gates. Lonely white-way lights stand guard over miles of cement sidewalks, where grass and palmetto take the place of homes that were to be.... Whole sections of outlying subdivisions are composed of unoccupied houses, past which one speeds on broad thoroughfares as if traversing a city in the grip of death.

Bank clearings for Miami had climbed sensationally to over a billion dollars in 1925 but dropped sharply after that (see Table 2.1).

Table 2.1 Bank clearings for Miami. (Allen 1931)

Year	Amount
1925	US\$ 1,066,528,000
1926	US\$ 632,867,000
1927	US\$ 260,039,000
1928	US\$ 143,364,000
1929	US\$ 142,316,000

As Allen summarized,

Most of the millions piled up in paper profits had melted away, many of the millions sunk in developments had been sunk for good and all, the vast inverted pyramid of credit had toppled to earth, and the lesson of the economic falsity of a scheme of land values based upon grandiose plans, preposterous expectations, and hot air had been taught in a long agony of deflation.

2.2.3 Underlying Causes

Allen provided seven contributing factors to the Florida land boom:

1. Florida's favorable climate
2. Accessibility to the populous cities of the Northeast
3. Portability of people with automobiles
4. Aura of confidence pervading the population during the 1920s
5. The desire to live in a country club environment
6. The motivation to emulate the success of selling Southern California
7. The belief that Florida land offered the best chance to get rich quick

These were all factors that made Florida attractive. In the early 1920s, Florida became a popular place for vacations or relocation because of its climate. The population grew steadily and housing could not match the demand, causing prices to increase sharply, which was not exactly unjustified at that point. But, as prices doubled and tripled, the word spread and speculation began. Soon, nearly everyone in Florida was either a real estate investor or a real estate agent. This was a classic case of the phases of speculation as discussed in Sect. 1.8. Initially, people invested in Florida real estate because it was an attractive location. This caused prices of real estate to rise. In the second stage, as the prices of real estate increased even more, speculators moved in to buy real estate, not to dwell in the housing they own, but with the intent of turning over their holdings to another speculator who would arrive on the scene later, having noted the expanding bubble in housing. In the speculative stage,

the original reason for investing in Florida real estate was forgotten, and investments were made only to soon turn over the investment to “a bigger fool.” As the frenzy built, speculators borrowed to increase their leverage and thus expanded the bubble until it eventually popped.

2.3 The Stock Market and the Economy of the 1920s

This topic has already been discussed to a considerable degree in Sect. 1.8.2.3.

2.3.1 The Real Economic Boom of the 1920s

If you query “Google” on the Internet, you find a huge number of articles and websites that address the stock market crash of 1929 and the ensuing depression of the 1930s, but very few sites that deal with the actual boom of the 1920s, which was clearly a proximate cause of both the crash and the ensuing economic depression. The reason for this seems to be that in our culture, we have a deep and pervasive belief that it is only right and natural that stocks should go up, even by huge percentages, and such increases in asset prices are neither unreasonable nor demanding of explanation. However, when stocks go down, that is considered to be remarkable and deserving of study, examination, and even incrimination. When stocks crash, it is a national calamity requiring investigations, allegations, and accusations.

There are many factors that contributed to the economic boom of the 1920s.⁹ The First World War had accelerated the gradual transition of America from an agrarian nation toward an industrial nation, although agriculture still played a much larger share than it does today. The advent of mass production in electrically powered factories with assembly lines produced products efficiently at low prices. Automobiles became commonplace and the majority of American households owned cars by the end of the 1920s. The automobile and trains revolutionized transportation. The workweek dropped from 60 to 48 h, and Americans had more time for leisure. The consumer outlook was optimistic. Taxes were low, and businesses and individuals were able to retain much of their earnings. As Fig. 1.12 shows, the uppermost income tax bracket during the second half of the 1920s was 25 %—the lowest it has ever been. Similarly, the capital gains tax was the lowest it has ever been. There was an

⁹ Aylen (2001).

ample money supply. Advertising became a big business, and America became a consumer society driven by the urgings of the advertisers.

Unlike the era of the late twentieth century, where “free trade” has been widespread among nations, high tariffs were placed on imported goods in the 1920s, promoting production and distribution of goods made in America. This also contributed to American prosperity. However, other nations were not so fortunate. Since the USA relied on its own reserves of national resources,

...little money had to leave the United States to buy the raw materials needed to manufacture its products. This created an unbalanced cash flow from the rest of the world to the United States. As a result, European nations, still recovering from the [First World] War, needed loans, which they got from American banks. This sent even more money to the United States in the form of repayments and interest, leading to an even more unbalanced cash flow, and so on.¹⁰ Aylen (2001)

Furthermore, Europe’s recovery from World War I did not revive to prewar levels of production, and the Europeans failed to reclaim their old markets from the USA or create new markets to compensate for the losses. As a result, nations still maintained high tariffs, which raised prices and cut world trade.

This question has been debated by economists for more than 100 years, as to whether tariffs promote or oppose prosperity. Most economists in the twenty-first century seem to be enthusiastically in favor of free trade, and it is widely believed that tariffs contributed to the worldwide depression of the 1930s. There seems to be some merit to this argument. However, as in most economic questions, the issues are complex. In an ideal world composed of nations of roughly equal size and gross national product (GNP), without cartels and other artificial controls of supply and demand, one can rightly argue that with free trade, each nation can produce the products for which it is most capable and efficient. Without trade barriers, all nations benefit from the most efficient production wherever it may occur, and prosperity would be shared by all. Free trade is believed to be a boon in such a world. However, this seems to be the hypothetical world of economists. (I attended a lecture by a noted advocate of free trade, who explained how one country would produce autos, and another would produce TV sets, etc. Someone in the audience raised the question: “What will the US do?” Another person in the audience shouted: “Consume!”) In the real world of the early twenty-first century, with the US being a major industrialized power, and many developing countries anxious to industrialize with cheap labor, free trade provides short-term advantages

¹⁰ Post War Boom and Bust (1920–1929), <http://www.flowofhistory.com/category/export/html/151>.

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