

Preface

One of the problems that has challenged us for as long as we can remember is: how to value assets? In response to that challenge, we have invented the “free market economy” in which the price of an asset is set by the give-and-take between the buyer and the seller, one seeking the lowest price, and the other seeking the highest possible price. When demand is high, prices tend to rise, and *vice versa*. The two types of assets of greatest consequence to most of us are real estate and corporate stocks. According to classical economics, “the price is right” because it is set by negotiation between a rational buyer and a rational seller as to the “worth” of the asset. Unfortunately, history shows that at frequent intervals, this system gets seriously out of whack and the pricing of assets goes haywire. Stock and real estate prices are driven to “irrational exuberance.” A bubble forms, and inevitably the bubble bursts and there is great misery throughout the land. Then the cycle repeats itself—again and again.

What seems to happen is that some event, some expectation, or some new development starts the asset price rise rolling. As asset prices rise, a vacuum is generated that sucks in more investors, hungry for quick profits. The momentum so generated attracts yet more investors. By now, most new investors ignore or are oblivious of the original stimulus for the boom, and are only buying with the intent of selling at a profit to “a bigger fool” who is expected to come along soon. Greed descends upon the land like a ground fog.

We have seen this process repeat itself with a minor variations as far back as we can remember,¹ whether in tulips in Holland in the seventeenth century, the South Seas bubble of the eighteenth century, the Florida land boom of the 1920s, the stock market boom and crash of the 1920s, the great bull market in stocks of 1982–1995, the Japanese boom of the 1980s, the savings and loan scandal of the 1980s, the *dot.com* boom of 1996 to 2000, the sub-prime mortgage housing boom of 2002–2007, and more recently, the stock market bubble of 2012–2014.

¹ Early booms and busts were discussed in: McKay, Charles (1841) *Extraordinary Popular Delusions and the Madness of Crowds*. Richard Bentley, London. Reprinted Farrar, Strauss Giroux: New York: 1932.

To add to the confusion, the bubble atmosphere provides a playground for charlatans, schemers, and crooks within which to operate. The Republican Party has provided impetus to these corporate criminals by implementing “deregulation” and interpreting this as “no regulation.” In such an environment, banks and investment companies are free to play with the public’s money and be bailed out by the Government.

The first part of this book examines the nature, causes and evolution of bubbles, booms and busts in asset markets as phenomena of human greed and folly. In doing this, I have built upon the foundations laid down by John Kenneth Galbraith’s various works and I have also utilized material from Kindleberger’s work: “Manias, Panics and Crashes”, as well as various other sources cited in my book. Understanding bubbles, booms and busts requires first and foremost examination of the human element (greed, extrapolation, expectation and herd behavior).

The process by which a boom evolves into a bubble and thence to a bust is explored in detail. In many cases, there is a legitimate basis for expecting significant future growth (as with widespread electrification and the expansion of automobiles and highways in the 1920s, or the introduction and expansion of the personal computer and the Internet in the 1990s). This leads to investment of new money, which produces a boom. The boom expands into a bubble when the original basis for investing is gradually displaced by *momentum buying* when speculators invest only because the asset price is rising without regard to the merits of the organization. As prices rise, more speculators are sucked into the vacuum. Eventually, when the rate of rise reaches unsustainable epic proportions, the bubble pops.

Sornette and Woodward² discussed “the illusion of a *perpetual money machine*.” They said:

This term refers to the fantasy developed over the last 15 years that financial innovations and the concept that ‘this time, it is different’ could provide an accelerated wealth increase. In the same way that the perpetual motion machine is an impossible dream violating the fundamental laws of physics, it is impossible for an economy which expands at a real growth rate of 2–3 % per year to provide a universal profit of 10–15 % per year, as many investors have dreamed of (and obtained on mostly unrealized market gains in the last decade). The overall wealth growth rate has to equate to the growth rate of the economy.

² Financial Bubbles, Real Estate bubbles, Derivative Bubbles, and the Financial and Economic Crisis, <http://arxiv.org/abs/0905.0220>; updated October 2012 as The Illusion of the Perpetual Money Machine by Didier Sornette and Peter Cauwels, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2191509.

Sornette and Cauwels³ (SC) drew analogies with the laws of physics. Referring to the impossibility of a perpetual motion machine and the impossibility of creating energy out of nothing, they asked whether we can perpetually create wealth out of nothing? They said:

What about wealth? Can it be created out of thin air? Surely, a central bank can print crisp banknotes and, by means of the modern electronic equivalent, easily add another zero to its balance sheet. But what is the deeper meaning of this money creation? Does it create real value? Common sense, ... would argue that money creation that outpaces real demand is a recipe for inflation...

The rationality of investors comes into question. So does the rationality of bankers, who also display these same tendencies to an irrational degree. Events in 2008 showed that just about every major bank, brokerage house and mortgage company was rocked by multi-billion dollar losses in the sub-prime mortgage fiasco, and their stock values plummeted.

In addition, we examine how Government policy (monetary policy, fiscal policy, tax structure)—or the perception by investors that the Government will bail them out of a financial crisis—affects bubble formation and collapse. Bubbles require money. The money is supplied by banks, which in turn are enabled by loose government monetary policies. Government policies include manipulation of interest rates and tax laws. Over the past 35 years or so, Government policies have been skewed repeatedly to support bubbles in real estate and stocks. Low interest rates hurt savers, and most savers are not wealthy. Low income taxes (particularly on upper bracket income, capital gains and dividends) promote speculation and bubble formation, which benefit the rich. Asset bubbles enrich those who own assets. Therefore, it is relevant to examine who owns the assets in America. We found that a relatively small percentage of people at the top, own a large percentage of the assets. Hence preservation and enlargement of assets via bubbles preferentially benefits the rich, and that has been and remains the policy of the US Government. This raises the question whether asset bubbles create wealth, or vice versa? While classical economics might suggest that asset bubbles should merely create inflation, not wealth, there is considerable evidence in recent decades that wealth has been created merely by bidding up the prices of stocks and housing (on paper), thus defying the laws of classical economics (the so-called “wealth effect” of Alan Greenspan). As a result, the rich get richer (relative to the poor and middle class) and the disparity between the top and the bottom expands

³ The Illusion of the Perpetual Money Machine by Didier Sornette and Peter Cauwels, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2191509.

with time. The major supporter, architect and protector of bubbles over the decades prior to 2008 was Alan Greenspan who used Federal Reserve policies to support bubbles in almost every instance whenever it appeared. Since that time, Ben Bernanke has followed the same policies, promising Fed intervention every time the asset markets falter, and flooding the economy with borrowed money to generate a new bubble in the aftermath of the collapse of the previous bubble in 2008.

Much of the prosperity is confined to the rich. Most of the prosperity is due to the asset growth and since the rich own most of the assets, they have profited the most. By contrast, real wages (adjusted for inflation) have been relatively flat for some time. Modifications to the income tax structure by Republicans (with support of Democrats) have exacerbated this disparity. In addition to asset growth, a huge expansion in debt: federal, state, municipal and personal, has created the illusion of wealth. Ronald Reagan's introduction of "spend and borrow" as a new theme for the Republican Party over the past three decades, competes with the Democrat's "tax and spend" philosophy. In a widely quoted comment, then Vice-President Chaney voiced the Republican viewpoint: "Deficits don't matter." The combination of (1) asset bubbles, (2) expansion of debt, and (3) temporary control of inflation by purchasing cheap goods from China (while losing our manufacturing industries and blue-collar jobs) seems to have worked—but this shaky house of cards could easily collapse, and likely will.

The second part of this book examines a number of specific boom-euphoria-bust cycles during the last 100 years. Most of the emphasis is on American bubbles but a few overseas bubbles are also included.

The Florida land boom of the 1920s ushered in the era of boom-bust cycles in the twentieth century, when a single piece of property might trade six times in a single day with each purchase heaping promissory note upon promissory note until the whole thing collapsed.

The stock market in the late-1920s was a bubble in which stock prices rose incredibly from 1924 to 1929, and the general atmosphere was that of a gigantic bubble driven by euphoric investors, with heavy margin buying and leverage introduced via investment trusts. However, a number of learned articles claim that most stocks were not overpriced in 1929. There are many explanations for why the stock market collapsed in October 1929, and all of these provide insights; nevertheless an all-inclusive explanation has yet to be found. It appears that the economy topped out about three years before the stock market crash. The stock market crash of 1929 did not in itself cause the ensuing depression. We have discussed theories for the cause of the depression of the 1930s later in this book.

The savings and loan scandal of the 1980s was partly a bubble and partly out-and-out fraud, encouraged, supported and abetted by policies of the Reagan administration that blindly believed that deregulation (interpreted as no regulation) would solve an inherent problem of S&Ls in which their revenues from fixed mortgages would no longer cover their costs when interest rates on deposits escalated. The cost of bailing out failing S&Ls could have been contained if the Reagan administration had acted in a timely fashion; but it didn't, and unseemly speculators and criminals took over the S&L industry while Mr. Reagan kept his head in the sand. In the end, the taxpayers paid for the debacle after Mr. Reagan left office.

The *dot.com* mania of the late 1990s was based on a sound intuition that the Internet would have a profound positive effect on communications, business efficiency and information storage and retrieval. However, the boom very quickly turned into euphoria as new companies were created daily and bid up to incredibly high prices. The valuations (stock price $\times$ number of shares outstanding) given to minor emergent Internet businesses with no earnings often exceeded valuations of major companies like General Electric. It was inevitable that after the huge run-up in stock prices prior to 2000, the bubble would collapse in 2000; and it did collapse with a thud.

Mr. Greenspan tried to rescue the collapsing stock market with a series of drastic rate cuts starting in 2002, and to some extent he was successful. But an unintended (at least presumably unintended) consequence of the rate cuts was generation of a new huge bubble in residential housing prices from 2002 to 2007. This bubble was aided and abetted by the prevailing interpretation of deregulation of banks and home loan institutions as “no regulation”—allowing them to pursue speculative, risky, and in many cases just plain stupid policies regarding issuing mortgages without adequate down payments, and issuing gerrymandered loans to people who could not afford the payments, in the expectation that rising house prices would bail them out. This was further exacerbated by large financial institutions packaging large numbers of mortgages into investment vehicles that obscured the fragility of the underlying collateral. Once more the adage is proved that “the road to hell is paved with good intentions”. The desire of the Government to provide house ownership to those who could not afford it under previous regulations, pressured the government backed mortgage agencies to reduce the standards for issuing mortgages.

When the housing bubble popped in late 2007, as it had to, it dragged down the stock market as the realization spread that most financial institutions had lost countless billions in inflated real estate securities. However, once again “Helicopter Ben” and the Fed came to the rescue dropping down

money on the markets after every significant falter in the stock market. And with each money drop, the federal deficit inflated. It took a few years, but by 2012–2014 new bubbles were forming in stocks and real estate.

Perhaps most wondrous of all is not the repeated boom-bubble-bust cycle that we see over and over again in asset investments; but rather it is almost the religious belief of investors who prostrate themselves before the Federal Reserve with its rate-settings, as if like a Colossus astride the economy, it can single-handedly steer the ship of state to safety.

It appears that Eric Janszen's insights into bubble formation and popping may be correct.⁴ "The new economy belongs to finance, insurance, and real estate—FIRE" and represents "a credit-financed, asset-price-inflation machine" that is built upon a fundamental belief that the value of one's assets no longer fluctuates in response to the business cycle and the financial markets, but now mainly rises, with only infrequent short-term reversals.

Dr. Donald Rapp

April 2014

⁴ Eric Janszen (2008) The Next Bubble: Priming the markets for tomorrow's big crash, Harper's Magazine, February, 2008.

<http://www.springer.com/978-1-4939-1091-5>

Bubbles, Booms, and Busts

The Rise and Fall of Financial Assets

RAPP, D.

2015, XXVIII, 351 p. 70 illus., Softcover

ISBN: 978-1-4939-1091-5