BUBBLES, BOOMS, AND BUSTS

The Rise and Fall of Financial Assets

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Donald Rapp

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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 buyer and seller, one seeking the lowest price, and the other seeking the highest possible price. 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." 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 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 more investors. By now, most new investors ignore 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 minor variations as far back as we can remember,[1] whether in tulips in Holland in the 17th century, the South Seas bubble of the 18th century, the Florida land boom of the 1920s, the stock market

[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

boom and crash of the 1920s, the great bull market of 1982–1995, the Japanese boom of the 1980s, the savings and loan scandal of the 1980s, the dot.com boom of 1996–2000, and most recently, the sub-prime mortgage housing boom of 2002–2007.

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 is transformed into bubble and thence to a bust is explored in considerable detail. In many cases, there is a legitimate basis for expecting significant future growth (as with 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, which produces a boom. The boom expands into a bubble when the original basis for investing is gradually replaced by *momentum buying* when speculators invest only because the asset price is rising. As prices rise, more speculators are sucked into the vacuum. Eventually, when the rate of rise reaches epic proportions, the bubble pops.

The rationality of investors comes into question. So does the rationality of bankers, who also display these same tendencies to an irrational degree. There is evidence that bankers are among the stupidest of people. Recent events in 2008 show that just about every major bank, brokerage house and mortgage company has been rocked by multi-billion dollar losses in the sub-prime mortgage fiasco, and their stock values have plummeted.

In addition, we examine how Government policy (monetary policy, fiscal policy, tax structure) – or the perception by investors regarding the effects of Government policy – 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 thirty years, Government policies have been skewed repeatedly to support bubbles in real estate and stocks. Low interest

rates hurt savers, and low income taxes (particularly on upper bracket income, capital gains and dividends) promote speculation and bubble formation. Asset bubbles enrich those who own assets. Therefore, it is relevant to examine who owns the assets in America. We find that a relatively few at the top own most of the assets. Hence preservation and enlargement of assets via bubbles preferentially benefits the rich, and that is, and has been 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. As a result, the rich get richer (relative to the poor and middle class) and the disparity between the top and the bottom expands with time. The major supporter, architect and protector of bubbles over the past several decades has been Arthur Greenspan who used Federal Reserve policies to combat fragility in bubbles in almost every instance whenever it appeared.

A great proportion of the apparent prosperity of our times is illusory. First of all, much of the prosperity is confined to the rich. Most of the prosperity is due to 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 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 two decades, competes with the Democrat's "tax and spend" philosophy. Vice-President Cheney 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 20th 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 have claimed 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. Similarly, the explanations for the ensuing depression of the 1930s are diverse, but it is still not entirely clear why the depression was so profound and so lengthy.

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 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 × number of shares outstanding), given to minor 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 collapse it did 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 the 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.

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 dollar weakened, the price of oil shot up, and the price of gold inflated.

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 the almost 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.

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Introduction: The Holland Tulip Mania of 1636–1637

History shows that there is a deep-rooted human urge to make a quick profit without working for it by trading in paper assets. One of the first documented boom-bubble-bust cycles was the "tulip craze" that took place in Holland in 1636–1637 when buying and selling tulips became a national mania that led otherwise rational people into mortgaging their worldly goods to invest in tulips.

Tulips originated in Asia and Turkey, where they were cultivated and propagated in Turkey almost a thousand years ago. They were introduced into Holland for the first time in 1563, where they were propagated and studied by a Dutch botanist from the 1570s to the 1590s. The culture of tulips and propagation from bulbs or seed is a slow process. By 1600, tulips were in some demand throughout Europe but supplies were limited. The colors of tulips began to change due to a virus and some magnificent tulips evolved. Tulips were valued by their color, and a hierarchy of tulips evolved with the most desirable ones bringing very high prices. A tulip called "*semper augustus*" was the most highly prized of all, and quickly became very valuable.[2]

Between 1600 and 1630, Dutch tulip growers propagated more tulips, and tulip sales became a thriving business. Tulips were taken out of the ground after the blooming season and dried and stored for the summer to preserve them prior to replanting in the fall. Most sales therefore took place in mid to late summer when the bulbs were accessible. With the passage of time, tulip prices rose significantly, but in an orderly fashion.

In this era, some Hollanders became wealthy through trade with distant lands, but the great majority of the Dutch were artisans or farmers who worked long hours for subsistence wages. It was tempting to these laboring people to try to earn some additional money by acquiring and propagating tulips themselves. Thus,

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[2] "Tulipomania", Mike Dash, Three Rivers Press, 1999.

with the expansion of the tulip market, a number of amateurs began growing tulips for sale in the early 1630s.

Dash described two national propensities of the Dutch of that time: savings and gambling. The plague killed off a number of people during the 1630s, leaving a shortage of labor. Wages went up as a result, and artisans had some extra savings to gamble on the tulip trade. Tulip prices rose considerably from 1630 to 1635, and the interest in earning profits from tulips expanded amongst the populace during that period.

The demand for tulips was such that a market that only existed for about two months in late summer was inadequate. As a result, in 1635, an important change was made in the way tulip sales were carried out. Instead of an exchange of cash for bulbs in late summer, the transactions could now take place at any time of the year, even while the tulip bulbs remained in the ground, and the exchange of cash was for a contract in which the bulbs would be made available to the buyer at the next late summer opportunity. This introduced several issues because the buyer was not sure exactly what he was getting, and the care of the sold bulbs was not always ideal. At the same time, many sales were made on contracts in which the buyers put up little cash, but paid a down payment in kind, with personal goods, and promised to pay the seller a large cash payment after the buyer took possession (based on the expectation that he could sell the bulbs to another buyer at a higher price). Most of these people could not possibly come up with the cash required at completion of the deal, except by selling their tulips to a hypothetical future buyer.[3] Very often, the down payment was a small percentage of the total price. Thus, buyers were highly leveraged. With these changes in the market, there was no need to know much about growing or propagating tulips. Investments were now made for the purpose of resale, not for the purpose of use. Thus, the tulip market passed from a boom phase to a mania phase.

Beginning in the autumn of 1635, prices escalated and as they did, more and more investors were sucked into the market to buy, driving prices higher and higher. By 1636, tulips were traded on the stock exchanges of numerous Dutch towns and cities. This encouraged trading in tulips by all members of society, with many people selling or trading their other possessions in order to speculate in the tulip market. By the autumn of 1636, a single tulip bulb could command a price equivalent to a few years' average salary, and the top bulbs were priced at several decades of average salary. Prices rose by a factor of ten from November 1636 to

[3] If this sounds familiar in 2008, it is because this was the same philosophy of those who bought housing that they could not afford during 2004–2007 with the expectation that rising prices would bail them out.

January 1637. The peak in the market occurred in early February 1637, when an auction of tulips netted 90,000 Guilders.[4] However, at an auction a few days later, there were no bids. This led to a nationwide panic as buyers disappeared from the markets. The ensuing collapse of the tulip market was swift and profound. By the spring of 1637, tulip prices had dropped by factors of 20 to 100. Many of the relatively common tulips became completely worthless. As in the case of the Florida land boom of the 1920s, a given tulip may have been bought and sold several times, each time with a small down payment and a promissory note. As each buyer defaulted, they left behind a tangled web of unpaid bills.

Had the tulip transactions been enforced, those who had mortgaged their few possessions to enter the tulip market would have been ruined – implying consignment to the workhouse, or starvation. Attempts were made to resolve the situation to the satisfaction of all parties, but these were unsuccessful. Ultimately, individuals were stuck with the bulbs they held at the end of the crash—no court would enforce payment of a contract, since judges regarded the debts as contracted through gambling, and thus, not enforceable by law. In many cases the people who owed had no assets worth suing for anyway. It appears that after the collapse of the tulip market, the courts decreed that all purchase contracts would be treated as options to buy and need not be fulfilled.

Dash described the end result of the tulip craze as surprisingly benign. Most of the crazy deals were negated and life went on, although bankruptcies increased and there are other signs of financial stress in the aftermath. However, Galbraith claimed that a recession followed the puncture of the bubble.

[4] For calibration, an artisan's salary was about 300–400 Guilders/year and a prosperous merchant may have earned 1,000 or more Guilders per year.