Asset Price Bubbles

When a monetary authority expands the supply of currency based claims in an economy, the new units of money enter the economy at a specific point in time and into the hands of specific market participants, and then spread out gradually as the new money changes hands in successive trade transactions. Over time this causes most if not all prices to adjust upward, due to the new equilibrium of the money supply vs demand equilibrium in the familiar process of price inflation, but this does not happen instantaneously to all prices. Early recipients of the new money are thus able to bid up prices for the assets and goods that they purchase before prices in the rest of the economy rise. This is part of the economic phenomenon known as a Cantillon Effect .

When buying activity in the market is focused on a specific asset class of assets or economic goods by the circumstances of the time, then the relative prices of those assets rise compared to other goods in the economy. This is what produces an asset price bubble. The prices of these assets no longer reflect just the real conditions of supply and demand relative to all other goods in the economy, but are driven higher by the Cantillon Effect of the new money entering the economy. When an asset price begins rising at a rate appreciably higher than the broader market, opportunistic investors and speculators jump in and bid the price up even more. This leads to further speculation and further price increases not supported by market fundamentals. The expectation of future price appreciation in the bubble assets itself drives buyers to bid prices higher. The resulting flood of investment dollars into the asset pushes the price up to even more inflated levels. The real market price distortion starts when everyday people, effectively the last recipients of the newly created money as it trickles down through to their wages and business income, take notice of the market price increases and decide they too can profit from rising prices. Because the new money is now fully circulating throughout the economy it no longer has the power to continue pushing the relative prices of the bubble assets up compared to other goods and assets. Early recipients of the new money sell to the latecomers, realizing outsized profits. These late buyers however realize little or no gains as the price bubble stalls for want of new money.

The bubble then begins to deflate. Other prices in the economy are rising to normalize the relative prices of the bubble assets, dampening and no new money is entering the economy to fuel more bubble price rise, both of which also dampen expectations of future bubble price appreciation. Late buyers are disappointed by lackluster gains and the speculative optimism that magnified the bubble‘s rise now reverses. Bubble prices begin to fall back toward those implied by market fundamentals.
When the flow of new money stops, or even slows substantially, this can cause the asset bubble to burst. This sends prices falling precipitously and wreaks havoc for latecomers to the game, most of whom lose a large percentage of their investments. The bursting of the bubble is also the final realization of the Cantillon Effect, as not just a change in relative prices on paper during the rise of the bubble, but a large scale transfer of real wealth and income from the late comers to the early recipients of the newly created money who started the bubble.

When this process is driven by a form of a fiat currency mostly made of fractional reserve debt created by the central bank and the banking system, then the bursting of the bubble not only induces losses to the then current holders of the bubble assets, but it can also lead to a process of debt deflation that spread beyond those exposed directly to the bubble assets but to all other debtors as well. This means that any sufficiently large distortions of the markets ability to correctly price assets can via an asset bubble crash the entire economy into recession under the right monetary conditions.

It is the manipulation of the supply vs demand equilibrium price within a free market which precedes all historical economic crises, as Government policies that seek to shape economic trends are almost guaranteed to underpin via monetary flow distortions associated with the market price distortions and asset price bubbles always follow.