BOOM AND BUST

A Global History or Financial Bubbles

# Written By:

William Quinn

JohnD. Turner

# Preface

Why do stock and housing markets sometimes experience amazing booms followed by massive busts and why is this happening more and more frequently?

Understand why bubbles happen, and why some have catastrophic economic, social and political consequences whilst others have actually benefited society:

Bubbles start when investors and speculators react | new technology or political initiatives, showing that our ability to predict future bubbles will ultimately come down to being able to predict these sparks.

# CONTENTS

## I THE BUBBLE TRIANGLE”

The definition of a bubble we take to be an undertaking which is blown up into an appearance of splendour and solidity, without any probability of permanence,

We have to turn the page on the bubble-and-bust mentality that created this mess¸² Bubble-and-bust - President Barack Obama

Bubbles can encourage overinvestment, overemployment and overbuilding, which ends up being inefficient for both businesses and society.’ [In

Estimates, however, conceal the large costs that financial crises have on psychological and well-being. They also ignore the human costs associated with the imposition of austerity measures once the crisis is over. We both experienced and witnessed cuts in real pay. Decreased levels of public service provision and T cuts in welfare payments to family members.

Three ways in which bubbles can be useful.

* Facilitate innovation
* Stimulate future innovations
* Provide capital technological projects that would not be financed to same extent in a fully efficient financial market.

Associated with transformative technologies, such as railways, bicycles, automobiles, optics and the Internet.

Word ‘bubble’, in its present spelling, appears to have originated with William Shakespeare at

-the famous ‘All the world’s a stage’ speech from his comedy As You Like It,

- as an adjective meaning fragile. – empty or worthless, just like a soap bubble.

Widely used as a verb. Meaning to deceive’.

Used by commentators and news media to describe any instance in which the price of an asset appears to be slightly too high.

As a non-explanation of a financial phenomenon, a label applied only to episodes for which we have no better explanation

Eugene Fama, the father of modern empirical finance, view the word ‘bubble’ is devoid of meaning, having never been formally defined.14

Charles Kindleberger, the MIT economic historian and bubble scholar, who describes a bubble as an ‘upward price movement over an extended range that then implodes’. In

Others have suggested that, for an episode to constitute a bubble, prices must have become disconnected from the ‘fundamental value’ of the asset. 16 However, this definition makes bubbles much more difficult to identify with any certainty. Which can lead to lengthy discussions about whether a particular episode was a ‘real’ bubble or not. It

Can only be identified with 100 percent certainty after the event.

### The Bubble Triangle

The oxygen for the boom, is marketability: the ease with which an asset can be freely bought and sold.

Divisibility: if it is possible to buy onlY a small proportion of the asset, that makes it more marketable.

The fuel for the bubble is money and credit. Abubble can form only when the public has sufficient capital to invest asset, and is therefore much more likely to occur there is abundant money and credit in the economy.

Investors would often rather invest in something ridiculous than accept a low interest rate on a safe asset.

Speculation is the purchase (or sale) of an asset with a view to selling (or repurchasing) the asset at a later date with the sole motivation of generating a capital gain?!

Speculators, many of whom numbers trade purely on momentum, buying when prices are rising and selling when prices are falling.

May Purchase an asset they know to be overpriced, planning to re-sell the asset to ‘a greater fool’ to make a capital gain. This practice is commonly referred to as ‘riding the bubble’

Difficult to distinguish investors who rode the bubble from those who were lucky enough to sell at the right time.

According to Vernon Smith, a Nobel bubbles start - according to Vernon Smith, a Nobel In this book, we argue that the spark can come from two sources: technological innovation, or government policy.

It might be part of an attempt to reshape society in a way that the government deems desirable: several housing bubbles, for example, have been sparked bY the desire of governments to increase levels of home ownership. The first major financial bubbles, described in Chapter 2, were engineered as part of elaborate schemes to reduce the public debt.

The most long-standing existing explanation for bubbles is irrationality (or madness) on the part of individuals and concomitant mania on the part of society. One of the earliest expressions of this explanation came from Charles Mackay, a Scottish journalist and writer, who first published his Memoirs of Extraordinary Popular Delusions and the Madness of Crowds in 1841.

Expanded by the likes of Kindleberger, John KenGalbraith and, most recently, Nobel Laureate Robert Shiller.30 Shiller and other economists argue that bubbles can largely be explained by behavioural economics, with cognitive failings and psychological biases on the part of | investors causing prices to rise beyond their objective val- : ue.

An overconfidence bias, whereby they overestimate the future representativeness bias, whereby they incorrectly extrapolate from a series of good news announcements and overreact

Other investors may simply follow or emulate this subset of investors simply because of herd behaviour and naivety on their part.

### Historical Bubbles

We can see a similar process of myth-making, whereby bubble anecdotes that were originally satire or propaganda are repeated years later as if they really happened.

## 1720 AND THE INVENTION OF THE BUBBLE

For each country the challenge was reducing the debt in a way which minimized both the risk of revolution and the cost of future borrowing. It was therefore crucial to prevent the cost of additional taxation from landing too heavily on those with political power. In addition, defaults, which were normally only partial, must somehow be portrayed as justified and/ or unlikely to be repeated.

Scottish financial theorist alost single-hande treatises on economics, most notably Money and Trade Considered, which was published in 1705. Virtually every serious work about Law has emphasised both his reckless character and his genius: the famous Harvard economist Joseph Schumpeter placed him ‘in the front rank of mone tary theorists of all times’.

Propose the establishment of a ‘General Bank’ as a branch of government. The

Despite the fact that the Bank was nominally a private company, Law understood that its success depended on the backing of the political authorities. He therefore ensured that a large proportion of its shares were distributed to influential noblemen.

Interest in the success of the scheme,

Law attracted the attention of speculators by using an array of ‘market management’ tricks to engineering series of rapid increases in the Mississippi share price.

January 1720, when he was appointed Minister of Finance. He soon discovered, however, that he could not susprices indefinitely, and his attempts to do so became

An instrument called the ‘Visa’ was set up, to I which all assets relating to Law’s regime were submitted, accompanied by a statement outlining how the assets were obtained. The purpose of the Visa was ostensibly to convert these assets into a public debt ‘based on the realm’s these assets into a public debt ‘based which in practice meant favouring those with small holdings. Political environment was by then so toxic, however, that the government was forced to reverse the reduction of its debt repayments that Law’s system had enabled.

The debt burden to the status of a national emergency. In January 1720 the directors of the South Sea Company, a slave-trade firm that had helped the government refinance its debt in the past, presented a potential solution to Parliament. The essence of the proposal solution to Parliament.

Following the payment of several strategic bribes to wavering MPs, this offer was accepted by Parliament. 26 Debt subscriptions, whereby creditors could submit debt for South Sea shares, were arranged for late April, mid-July and early August 1720.

Since the mechanics of the scheme were such that a higher market meant greater sales of surplus stock, the directors (according to Anderson) could profit substantially by generating a bubble.

Alternatively. The directors could have used inside information to ride the bubble, as | alleged by the 1721 Commons committee.

Debt holders were supposed to : exchange government debt for shares in a company that held (virtually) nothing but the promise of a reduced rate of interest on this debt, and that had incurred significant additional liabilities in the form of promised cash pay” ments to the government.

## Causes

The Victorian middle classes loved the neat moral message about fiscal responsibility loved the neat moral message about fiscal responsive popularity owes a lot to a series of colourful anecdotes that supposedly illustrate the extent of investor stupidthat

The most enduring of these anecdotes concerned a million-pound undertaking entitled ‘A Company for Carrying on an Undertaking of Great Advantage, but Nobody to on an Undertaking What It Is’,

The satirical pieces were, of course, not supposed to be taken literally: but Mackay also failed to place them within their cultural context. From 1720 onwards a growing religious movement concerned with moral decay seized upon the South Bubble as the embodiment of society’s problems.

This spread a popular conception of the bubble that ignored its political nature in favour of a simple nar of an ‘extraordinary popular delusion’.

A more conventional way of valuing an asset to compare its price to its associated discounted cash flows, making allowances for uncertainty and liquidity.

Even this valuation was based on unrealistically optimistic assumptions.s?

### Consequences

Effect on GDP has not been reliably estimated, the available economic data supports the abundant qualitative accounts of economic ruin.

Price level in Paris fell by 38 per cent in 1721, a more severe deflation than the United States experienced during Great Depression.

Most histories of the first financial bubble have been framed bY the assumption that its consequences were negative.

First, the Mississippi Bubble involved a direct effort to overhaul the country’s currency, and thereby drew in a much greater proportion of the population. In 1720, simply holding gold, silver, jewellery or notes was enough to expose any individual to the whims of John Law’s scheme.

Most of those who lost money could afford to do so and the scale of bankruptcies not enough to cause a chain of defaults that could led to a full-blown financial crisis.

Britain, under pressure from South Sea Company, passed the Bubble Act in 1720, which forbade the formation of any joint-stock companies | the absence of parliamentary approval.

The importance this Act may have been overstated — joint-stock comwere already illegal under the common law - but in any case, very few formed after the South Sea scheme collapsed

## MARKETABILITY REVIVED: THE FIRST EMERGING MARKET BUBBLE

Of the key ingredients of this bubble -an avaricious and dishonest politician. The politician targeted in the poem dishonest politician.

The politician targeted in the poem Bubble Spirit, who earned the moniker ‘Bubble Wilks’ because of the various far-fetched companies he Wilks’ because of the various far-fetched

One of his main was to give these companies an air of respectability persuading MPs and peers to become directors

Independent countries came to London to raise funds for their military, possibly at the active solicitation of British financiers. The first batch of Latin American loans was issued in 1822 to Colombia, Chile, Peru and the mythical country of Poyais in Central America.

* Ruled by the infamous General Gregor MacGregor, a Scottish adventurer, mercenary and narcissistic fraudster.
* As well as inducing investors to give him £200,000, he also convinced many Scots that they should emigrate to Poyais. Most of the first two shiploads (about 250 people) died soon after reaching the malaria-infested fake country: His con was eventually exposed, and by 23 January 1824, the Poyais bonds were worthless.

First, the physical difficulties of getting machinery men, provisions and materials to remote mines -roads were poor, rivers often impassable and mines were usually miles from the nearest port.

Major personnel difficulties. Locals unwilling to work and to adhere to contracts, most unwilling to work and to adhere to contracts, most cornish workers were permanently inebriated and mines were so difficult to inspect

Newly independent Latin American nations were subject to political instability, suffering from expropriation by politicians and weak contract enforcement. Re

Newspapers played a key role in this first emerging marbubble. On the one hand, their editorials were sceptical many company promotions were branded by the press ‘bubbles’ or ‘schemes’ 41 The Times warned its readers about the new fanciful company promotions and advised not to become dupes of their own imaginations

Ment possibilities and fabled precious metals of Mexico. It bought in newspapers to laud any Latin American country that was about to about to issue bonds. 47 The newspapers thus helped to develop and shape the narrative which en couraged people to invest in Latin American enterprises.

Causes

Francis, a director of the Bank of England, was also eyewitness of this national epidemic of speculation.

One major similarity to the South Sea episode was the widespread use of part-paid shares by new companies. Feature enabled a moderate rise in share prices to produce a large profit because only rise in share prices to produce a large profit because ʊ…у

The possibility of making an shares when they were sold. The possibility of making enormous profit while only risking a small sum waɔ \*- lation to the masses.

These shares were usually much more mar ketable than those of established companies because they were issued in much smaller denominations.

Consequences

Markets and the Bank of England. Then, at the beginning of December 1825, a major London bank, Thornton and Company. Which had been investing apse was followed by a series of bank runs and failures of lapse was followed bY a series of bank runs and failures of 1825, the notorious day of terror’, in

Almost 18 per cent of the English banking system failed so

Why was the banking system so vulnerable to the collapse of the 1825 boom? Regulation at the time meant English banks were restricted to the partnership form of organisation and, if they wanted to issue notes (which most banks of the time did). They could have no more than most banks of the time did), they could very small, making them vulnerable in

* Shocks to partner wealth gave them the incentive to invest bank’s money in risky assets in an effort to recover the bank”
* Small equity cushions to absorb the losses arisbanks had small equity cushions
* Effectively forced banks to restrict their operations one narrow geographical location,

The aristocracy and landed gentry, the political elite at the time, supported this regulation because it restricted the credit extended to small farmers, enabling landlords to maintain power and social control over them.

First emerging market bubble was the birth of financial journalism.88 1825, newspapers began to publish city columns, cover company newspapers began to publish city columns, cover commenton movements in and the state of the market.

And 1825 were therefore largely responsible for the rise of the press as a watchdog of the financial system, barking whenever things did not appear right. But how effective

Press was instrumental popping - but not preventing - the bubble in UK railway popping

## DEMOCRATISING SPECULATION: GREAT RAILWAY MANIA

The Economist, in 2008, described the Railway Mania as ‘arguably the greatest bubble in history’. This is not just modern hyperbole. Charles Mackay, in the third edition of Memoirs of Extraordinary Popular Delusions and the Madness of Crowds, wrote that the Railway Mania was greater than anything that had preceded it.4 Karl Marx, in Das Kapital, referred to it as the ‘großen Eisenbahnschwindel’, which literally means the ‘great Railway Mania’s

Revolutionary technology was beginning to transform Britain: steam-powered railways.

The Liverpool and Manchester in 1826. This railway, which was the UK’s first passenger railway, opened in 1830

This mini promotion boom was accompanied by a boom and bust in railway share prices, with share prices rising by 65 per cent and then falling by 45 per cent between May 1835 and May 1837.

Went into reverse, with more miles of railway abandoned went into reverse

Gladstone was particularly keen to constrain regulation. Gladstone was particularly keen to constrain their potential monopoly power, but he was also keen to develop a national rail network, which would avoid unnecessary duplication.

The Economist, cheerleaders for free trade and competition, declared that whether new railway companies should be established in competition with existing ones should not be left to the likes of Mr Gladstone; rather (and somewhat unfortunately as events would prove), they suggested that those who invest their money are the best judges¸¹4

Scrip certificates (or scrip as they were commonly known) were issued to individuals who had been allocated shares and paid up their 5 per cent. The fictional Glenmutchkin Railway issued 12,000 shares of £20 each, which meant that successful subscribers initially paid only £1.

However, the original holder of a scrip certificate : remained legally liable for all the debts of the railway until it was incorporated, and buyers of scrip would have been in a dubious legal position if they had wanted to sue the promoters for losses.

The railways that were applying to be considered moted and raising capital. However, this was completely overshadowed bY the scale of promotion adverts that were placed in the autumn of 1845.

When it tended to reflect the positivity of the railway market, with upward price movements typically followed by positive press coverage.

First, the abolition of the Railway Board and the free for-all promotion craze meant that, rather than benefiting from the positive externalities of a well-organised network, began to compete wastefully against one anoth er.

Second, there was a very poor harvest in England and Scotland, and a disastrous one in Ireland, where the potato crop failed due to blight. BY the middle of October, severity of this situation had become clear, 36 In De

Sparked a political crisis when the Minister, Robert Peel, temporarily resigned

Third, the outflow of gold due to problems with the har prompted the Bank of England to increase its inter prompted the Bank of England to increase its interper cent on 6 November¸37

Fourth, the sharp fall in railway share prices may have been precipitated by the large calls on capital made by the railways which Parliament had just authorised in July and august 1845.

A pamphlet was published which alleged that the railways controlled by George Hudson, the ‘Railway King’, charging expenses to capital rather than revenue, allowing them to report artificially high profits and pay higher dividends than were warranted, 40

Hudson had over-allocated scrip to himself, made related-party transactions between railways that he controlled and manipulated company accounts to overstate and dividends. Hudsa

Fraudulently pumping up earnings and dividends during the boom, but to sustain his empire after the crash.

To the construction of the Tan b’ the rest of the stock market. In 1838, railway shares constituted 14 per cent of all quoted stocks and 23 per cent of total stock market value. By 1848, railways made up 48 per cent of quoted stocks and 71 per cent of total stock market 46

### Causes

15 new stock exchanges opened around the country during the Mania to meet the demand the growing speculator franchise. 48=$

The growth of the middle classes and the fact that very low initial investments were required up front meant that part-paid shares played a major role in democratising speculation during the Railway Mania.

Even went as far as suggesting that ult LLLLL prices up and, in their panic, contributed to the collapse of prices up and, in their på

But many of these representations of investors come from the satirical press and contemporary lit SOUrceS | S&amp;

56 One of the epigraphs to this chapter is from William Makepeace Thackeray’s satirical poem The Speculators, where he depicts impecunious rogues talking about becoming rich through their investments in railways.

The lists will under represent the middle classes because railway promoters preferred to have their subscription lists packed with the upper classes and gentry.

A corner is the main way that Dunshunner and M’Corkindale, the promoters of the fictional Glenmutchkin Railway, made money on their scheme. One of the members their provisional board - a prosperous Presbyterian coffin maker called Samuel Sawley started to bear the shares by short selling

M’Corkindale launched a corner by buying up every available share offered for sale.

Within a matter of days the shares risen to £17 because of Sawley’s need to meet his contractual obligations.

Sawley arrived in full funeral costume ‘a countenance more doleful than if he had been attending the interment of his beloved wife’. He confessed to short selling - ‘the devil tempted me, and I oversold’· and ended up paying nearly all he had to buy 2,000 shares Dunshunner.

1845, Parliament was flooded with applications, and ultimately authorised many duplicate and uneconomic schemes that destroyed one another through wasteful competition. The

As the long-established method of parliamentary procedure had worked well for development of canals and turnpikes, which were all local enterprises, parliamentarians were lulled into thinking that such a procedure would be equally good for railways - However, thy did not appreciate the importance of network externalities.

The main finding was that the worst | thing that they could have done is nothing and the best strategy was the one they followed, namely to expand own network to protect themselves from competition.

### Consequences

Lord John Eatwell suggests that the Railway Mania is malo of. R 1 1 1 - a prima facie example of a useful bubble, in that after the bubble had burst, investments of real social value were left behind.&amp;°

The huge reduction in the time and money costs of travelling made journeys possible for the masses, and more frequent (and comfortable) journeys possible for the middle and upper classes.

However, one must ask whether the social usefulness was as high as it could have been had the process of au thorising the railways and establishing a railway network not been so laissez-faire or ad hoc. One must also ask if a bubble was a prerequisite for creating a national rail netbubble

One study has estimated that the circa 20,000-mile rail system which had emerged by 1914 contained about 7,000 miles more than was necessary - the same social benefits could have been obtained with substantially less investment. 84

Subsequent poor performance of the railway companies and widespread inefficiencies which have plagued British railways down to the present day.

**Than the bubble being useful for society, it created a higgledy-piggledy network and a railway system full of long-term inefficiencies.**

Socially useful rail network and one that was profitable in the long run could have been constructed without the Mania. This would only have been possible if the political calculus of Parliament had been less wed to regional interests and thus better able to create an efficient national rail netrepressing unnecessary competition and duplicate § lines.

Enterprises were panies in the UK was removed when enterprises wer government approval. Marketability was unconstrained speculation was democratised.

## OTHER PEOPLE’S MONEY: THE AUSTRALIAN LAND BOOM

Losses were still mostly borne by those who could afford them, bankruptcies that occurred did not cascade into widespread defaults, and the affected industries were not so systemically important that they could undermine the entire economy. As the continuing popularity of Mackay showed, bubbles were remembered largely as mildly humorous fables, read by the middle classes as a form of entertainment.

Australian Land Room of the 1880s was different.! Its bursting plunged Australia into the longest and deepest depression in its history, with widespread poverty, homelessness and depression in its history.

Historian compares ‘Marvellous Melbourne’ to the biblical city of Babel: a wealthy and prosperous place which was eventually subjected to judgement and plagues in the form of financial crises, bankruptcies and lost fortunes

The Australasian Insurance and Banking Record stated that this would stimulate share prices and business activity. But this economic stimulus had an uneven effect, because the reduced interest safe assets encouraged investors to take more risks.

Savers responded to these E interest rate cuts by searching for a better yield. 10

Subdivide them into single-dwelling build for a profit or developed by the companies themselves.!!

Building societies were traditionally the major providers of housing finance for individuals who wanted to buy a single-dwelling house.

However, during the land boom they began to change their business model, providing finance for the emerging builder-speculators and property developers, 13

The first half of 1888, suburban land was often sold three or four times without any enhancements being made to it and with its price trebling.”’

In terms of land prices, the study finds that the average price per acre rose from £39 in 1882 and £166 in 1885 to £303 in 1888. By 1890, however, average land prices had fallen to £154.20

Such was the demand for shares of land-boom companies when they came to market that they were vastly oversubscribed and immediately sold at a premium. One commentator observed that ‘sometimes a newly-formed company is in the position of some of the creations at the time of the South Sea Bubble - it does not know exactly what line of business to take up, its shares going to a premium notwithstanding’.

Under the editorship of its founder Maurice Brodzky, who Tall. been described as the original muckraker, Table Talk ran a series of exposés on unscrupulous behaviour by landboom company directors

### Causes

Expansion of deposits was not matched by a concomitant increase in capital, with the result that banks became much more leveraged. In

Michael Cannon, in his polemic-cum-exposé The Land Boomers, is much less kind to the political elite - he argues that the Victorian Parliament became a land speculators’ club in which use of public office for private gain was commonplace 7

### Consequences

The liquidation of the land boom did not end with the col lapse of the land-boom companies and building societies. Trading banks - the very heart of Australia’s financial system - would also pay a heavy price.

## WHEELER-DEALERS: THE BRITISH BICYCLE MANIA

A cynical writer has said that, while panics run in cycles, the present mania began with a run on cycles. Money? ;

The transformation was remarkable: in the space of a few years, archaic and impractical devices turned into something closely resembling the bicycles we still use today. Th n 1. Inductm.

Initially most bicycle, tub and tyre firms were privately but in the early 1890s a w o th large firms incorporated, with most shar trading activity occurring on Birmingham Stock Exchange. On such firm was the Pneumatic Tyr Company, established in 1892 with a nominal capital of £300,000 which held the patent to product Dunlop-brand pneumatic tyres.

Dunlop tyres exceptional reputation, this company was uniquehad an exceptional reputation, this company was unique

Ernest Terah Hooley, who came up with a plan to profit by the company out, then re-floating it on the stock buying the company out,

Hooley had to borrow almost all of the £3 million; the purchase could be thought of as an early example of a leveraged buyout.

A higher valuation also required an expensive marketing campaign: gentlemen with ‘good reputations were paid to put their names to the prospectus, and various newspapers were paid to provide positive coverage.

These price rises were dismissed as a result of pure gambling, and the newspaper compared profits in cycle shares to ‘a run of luck at Monte Carlo’.

There were plenty of true believers did not need to be paid to publish propaganda about cycle promotions. As during the Railway Mania, periodicals for enthusiasts were a persistent cheerleader for the bubble. Cycling ran a weekly financial section in which it discussed developments in the market, generally with a positive slant.

Promoters understood that even the most well-informed investor could be attracted by the prospect of making quick profits by reselling them to a ‘greater fool’.

Made it possible to profit by subscribing for shares and immediately-selling them on secondary markets. As a result, the company’s initial owners, the promoters, the aristocrats paid to act as directors, the newspaper proprietors paid to provide flattering coverage and some initial subscribers all stood to benefit from the boom.

The market for cycle shares fared just as badly in 1898, ending the year 71 per cent below its 1897 peak. The

Industry continued to struggle the early years of the twentieth century; by 1910 only 21 of the 141 firms were still extant.

Carnaby neatly illustrated the type of person Victorian society would have expected to buy cycle shares: wealthy, frivolous and naive.

Only that base of investors was much broader than the stereo type suggests, but that it changed considerably over time. 4-

The cycle shareholder base after the crash looks quite different, suggesting that some groups successfully rode bubble and exited before the crash- Company directors reduced their holdings by 27 per cent, exploiting the absence of insider trading laws, while cycle manufacturers reduced their holdings by 32 per cent.

Most of these shares were sold to rentiers,

The sell-off of insider shares at the peak of the boom continued a notable theme of the Bicycle Mania: the exploitation of outside investors by those with privileged information.

### Causes

The average share denomination prevailing at the time was about £32, equivalent to around £3,800 today.48 By issuing shares in small denominations, cycle companies signalled their intention to attract as wide a range of investors as possible.

Contemporary reports of the Bicycle Mania often commented on speculation in disap proving tones: ‘rampant speculation’, ‘gambling’ and ‘harum-scarum’ were all used by the financial press to describe the market for cycle shares.

an element of moralising in this coverage, share transfer records suggest that speculation was common:

Strategy, known to contemporaries as ‘stag’ investing, was to subscribe for shares with the intention of selling them at a profit on the first day of trading¸ Often, these sales would already have been agreed before the shares even been allotted.

Short selling was not strictly regulated, this was theoretically simple: a trader could agree to sell shares in the future at today’s price, then wait until just before the settlement date to purchase them.

As a market that was sola suit

Bagot Tyre corner, one investor was forced to pay twenty-one times the face value of Bagot shares and subsequently faced a loss of £2,318; executing the strategy suc- | cessfully would have earned a profit of only £26. Havin

Having | cessruшy would have earned a profit of only £26. Having London’s High Court, where the consensus of the judge and jury was that short sellers who lost money in a corner were getting what they deserved.&gt;&gt;

Financial advice columns at the time typically cautioned against speculation in generbut were particularly wary of ‘speculating for the fall’ (i.e. short selling), while noting how rare it was among the 3 general public.56

Since these profits represented quick and spectacular they undoubtedly played a role in attracting fur ther speculative investors during the boom of 1897.

The presence of easy money. Marketability and specular effect of the bubble poses the question of why the bubble did not spread to the overall stock market.

Consequences

Growth rate reached 5 per cent in 1898 and 4 per cent in 1899.65 Unemployment fell from 7.3 per cent in 1895 to 4.3 per cent in 1899.66 Outside the West Midlands, the effect of the bubble’s bursting was minimal.

Recession in a small industry might spread the wider economy if it was an important part of sever production chains. But for the bicycle industry this was not the case: the associated technology was not adapted into the existing economy in the way that, for example, internet technology later would be.

Women an unprecedented lev tion, it eroded the social norm that expected upper-class | women to be chaperoned, and the difficulty of riding in the restrictive corsets of the time resulted in a ‘rational clothing’ movement and the development of more practical dresses.

Even before the bubble, cycling was already becoming popular, but the bubble gave companies additional capital to innovate and advertise, improving the technology while helping to bring it to national attention.

## DEMOCRATISING SPECULATION: THE GREAT RAILWAY MANIA

1 1 17 the United States, the decade following the conclusion of the war then characterised by abundant money. As as the newly unlocked savings of the middle classes continually looked for new investment outlets.

History's most spectacular crashes. Like many financial developments throughout history, part of an effort to raise money to pay for war.

United | States entered World War I in April 1917, believing that its outcome hinged on its ability to mobilise its forces as quickly as possible, creating urgent funding requirements for the government.

Woodrow Wilson’s administration concluded that the best way to fund the war effort was to sell vast amounts of bonds to the American public.

To ensure that these bonds were sold, the government launched a spectacular marketing campaign. The - 1 bonds were rebranded as ‘Liberty bonds’ in a direct appeal to the patriotism of US citizens.

The first Liberty bond drive was followed bY four more, of which were heavily oversubscribed.

Almost 23 million subscribers, at a time when the total US population was just over 100 million. This included unprecedented numbers of working- and middle-class investors

Unlike in the 2000s, institutions were very reluctant to hold them, preferring to limit their exposure to mortgages they could monitor themselves. This stance was ultimately justified, as the real-estate bonds performed very poorly, losing 75 per cent of their value between 1928 and 1933.14

As economic conditions worsened, the housing market collapsed, and by 1933 prices had fallen 30.5 per

The speculative element of the housing boom can be most clearly on a local level, especially in Florida, where bankers were most successful in recruiting politicians to their cause in order to bypass regulations.16

Floridian land market was structured to make speculation as easy as possible, partly through the extension of short credit.

Ponzi issued ‘unit certificates of indebtedness’ for $310 each, promising a dividend of 200 per cent in 60 days, supposedly the profits of his land development work near Jacksonville.

In practice, most investors agreed to reinvest their profits with Ponzi, relieving him of the need to pay these dividends.

Willingness of so many investors to believe in the prospect of such extravagant returns suggests a retail atmosphere or legal but misleading promotion schemes.

Was accompanied by another extensive government marketing campaign encouraging investors to buy foreign bonds, and cam on the back o a 1922 ruling that deregulated the process of issuing them in the United States

Curtail the issuing of broker loans, whereby money to curtail the issuing or Droкer loans, neither of these measures was effective. The discount rate increases inadvertently encouraged capital to return to the United States, because higher interest rates than were available at home had been one of the most attractive features of foreign bonds.

When domestic banks were pressured by the Federal Reserve to reduce broker loans, the gap was plugged

Newspapers were split over whether stock prices were excessive or representative of a new financial era.

Cautious advice was often undermined by editors who were reluctant | contradict the more optimistic views of well-known bankers + The Wall Street Journal essentially acted as a cheerleader for the stock market.

When the dust settled, the DJIA had ended the day down 6.3 per cent, at that time the greatest daily fall since before 1914. And worse was expected to come because these losses triggered margin calls - recalls of broker loans that forced leveraged traders to immediately sell their stocks to avoid default.

1.6 million shares changing hands in the first half hour, mostly from ruined margin accounts. The down-! Ward momentum led many holders to ‘sell at the market’ - in other words, to accept any price for their stocks.

This deliberately evoked panic of 1907 which, it was widely believed, had ended due to the intervention of a cartel of bankers by J. P. Morgan

This gambit initially appeared to have worked because stocks quickly recovered most of their losses. The DJIA, Having at one point been down 10.8 per cent, ended the day down just 2.1 per cent.

The Chairman of the Irving Trust, one of the country’s largest investment banks, issued a statement warning try’s largest investment banks, issued a stat unthinking majority it is time for courage on the part of those investors who have a real sense of basic worth’.18

Conclusion reached on the basis of ‘statements by leading bankers’ 50 This line was repeated by New York Daily News, giving it the unwanted record of having advised investors i to buy shares on every single day of the crash

The aggregate loss was barely believable: it had fallen by 23.6 per cent in 2 days for no obvious reason. To

The DJIA finally bottomed out on 13 November at a value of 198, having lost 48 per cent on 13 November at a vajut

The DJIA did not reach its minimum until July 1932, when it fell to 41, an incredible 89.2 per cent loss from its 1929 peak.

1929 the comments of powerful men had become so uniformly positive that they were ful men had become so uniformly

Newspapers continued to use the chorus’s over-optimistic opinions in lieu of facts throughout the crash: the New York Times headline on the morning after Black Thursday was ‘Worst Stock Crash Stemmed by Banks; Leaders Confer, find Conditions Sound”

Bubbles also saw the emergence of faWhile previous bubbles also saw the mous ‘characters’, the extent to which the pic is unusual It could be argued that this made financial stois unusual, it could be argued that this made tidilidi Siu idea that market movements happened for good reasons. And made it appear as if someone was in charge. Needless to say. Most of these articles aged very badly

Allowed newspapers to develop close relationships with the country’s most powerful men, and thereby access a reliable source of future stories. Second, it ensured that the newspapers could not be blamed for sparking a panic. If a major newspaper had correctly predicted the crash, If a major newspaper had correctly predicted the crash, it would have been heavily criticised for cal

They could evade responsibility when events did not transpire as expected. In the aftermath of the crash, newspapers often mocked the exact theories that they had been citing for several Years as expert opinion.

“This strategy thus helped the news media to walk the tightrope of maintaining some credibility without contradicting the special interests and access on which they depended.

### Causes

The decade before the crash saw a continuous increase in marketability, as a series of reforms and innovations made it much easier to buy and sell securities.

Liberty bonds, which allowed them to be bought in local branches, department stores and through payroll bank branches

Aimed to educate the public In the making it harder for fraudsters to take advantage of them in financial markets, but it also benefited genuine companies, because it was easier to sell stocks and bonds to more confident investors.63

Trad: lower than any level on record before the 1980s.º\* Trau 04 technology: telephone use expanded by 70 per cent over 1 technology:

As in previous bubbles, increasing marketability Was, to an extent, self-perpetuating: higher marketability increased the volume of trades, which in turn made stocks even more liquid.

The extent to which this exacerbated the stock market boom is is evidenced by the fact that the quantity of broker loans almost exactly tracks the DJIA for the period

The Federal Reserve has often been blamed for allowing the boom to develop through excessively loose monetary policy during the 1920s. This argument, however, does not fit the evidence.

The minutes of its meetings suggest that the Federal Reserve was, if anything, excessively concerned with curtailing margin lending when other areas of finance were more systemically important

In J. K. Galbraith’s famous his of the crash, he argues that its key feature was that all aspects of [stock] ownership became irrelevant except the prospect for an early rise in price’ 70 This was widely observed at the time: the New York Times noted in August 1929 that ‘the present modus operandi in the market appears to be the buying of leading issues for the purpose of passing them on to someone else at a higher price’.

American society, as well as its economy. Was dǝ CIT clla༴་སྐྱར T Sulitly, ས་ transformed by electrification in the years preceding the crash: per capita electricity production grew by 9 2 percent : between 1902 and 1929.73

Well as providing considerable benefits to consumers, cheaper electricity was useful in many other industries, and complimented another major economic shift: the rise of mass production. Famously

In March this worldview was often applied to investment. » ion of market participants’ was that ‘all former yardsticks must be disregarded and that new measures, if the market is to be judged aright, must be adopted’¸”

In previous studies of 1929, it has been more common to ask ‘what caused the crash?’ than to ask ‘what caused the bubble

The quantity of outstanding broker loans in the autumn of 1929 meant that any sufficient fall in prices would lead to a significant number of margin calls. This in turn would force traders to liquidate, depressing prices further. Essentially. The fuel for the bubble could be removed at any moment. This vulnerability widely understood, since the quantity of broker loans was widely understood,

### Consequences

US consumer spending overreacting to a stock crash would not be unusual - consumer spending is historically very responsive to share price movements - an and. While subsequent spending reductions can be attributed to deflation, there is no other obvious explanation for the reduction of 1929.

It could be that the apocalyptic tone of media coverage during the crash led households to anticipate a disproportionate economic impact, and households cut spending in response.

In human terms, this meant increased homelessness, increased infant mortality and increased rates of suicide.87 The secondary political effects were even worse, with the Depression a major factor in the collapse of several European democracies and, consequently World War 2

Crash caused the subsequent recession, it could only have done so through its effect on consumer spending, a mechanism which not all economists find convincing.

The Great Depression instead the result of the vulnerability of banking networks, the rigidity of the inter-war gold standard, and the failure of governments and monetary authorities to address the resulting deflation.

One of the companies to experience the most substantial bubble was the Radio Corporation of America, which was central not only to radio technology to the later development of both black-and-white and colour television.⁹

Experience of the Roaring Twenties offers two keY lessons on bubbles. First, the optics of the crash matter. The economic significance of a bubble does not straightforwardly derive from its direct effects on the incentives of shareholders and businesses: it is viewed bY Society is also important. When stock markets become culturally significant, a spectacular crash can affect consumer behaviour, and thereby have unexpected economic effects.94 Second, managing the bubble is much less important than managing its aftermath. In

As it turned out, stock market speculation was little more than a sideshow: what really mattered for the economy was the stability of financial institutions, The authorities comprehensively failed to uphold.

## OTHER PEOPLE’S MONEY: THE AUSTRALIAN LAND BOOM

The 1920s bubble, in the view of the F. D. Roosevelt administration, fatally undermined the case for leaving US ministration, rataшy undermined the case for leaving of 1933, introduced almost immediately after Roosevelt assumed the presidency. Required all companies issuing securities to disclose more information to potential investors, including independently certified financial state

Edit, with relatively few w forms of market manipulation were banned, with the Act arguing that manipulation was responsible for ‘sudden unreasonable fluctuations of security prices and excessive speculation on such exchanges and markets’.

In response to the extensive margin trading of 1929, strict limits were placed on how much money could be lent for purposes of buying shares:

Japan had emerged from the war in a surprisingly advantageous position: under the control of the world’s leading capitalist power, but situated beside the world’s great communist powers. Since post-war American foreign great communist powers. Since post-war American foreign of capitalism, Japanese prosperity became a key strategy of capital

Harry Truman’s administration enacted a series of New Deal-inspired reforms, which encouraged labour union growth and attempted to dismantle the oligarchical conglomerates (or zaibatsu) that had dominated Japanese conglomerates (or zaibatsu) that had dominated Japanese industry. It also invested heavily in education, overhauling the curriculum to better reflect American interests.

Success of this strategy was partly due to the efficiency of japanese companies, who pioneered the just in-time method of production to take advantage of the world-leading engineering abilities of the Japanese workforce. But it was also important that these goods could be sold abroad at a competitive Price. This was ensured by fixing the yen to an exchange rate which was, bY the mid-1960s, artificially low, making Japanese goods cheap for foreign consumers.

Determining their own manufacturing industry for three reasons. First, consumers benefited from cheap, high-quality goods. Second, Japanese imports initially constituted only a small part of the market, as the world

Third, for geopolitical reasons, the economic success of Japan was considered to be in the interests of the Western bloc.

Nixon, concerned by high unemployment and inflation, suspended the convertibility of the dollar into gold in 1971, hoping to allow the dollar to devalue.

However, he eventually convinced that devaluation was a necessary alternative to protectionist measures.

Result was the Plaza Accord: an international agreement, signed in 1985, in which Japan agreed measures to increase the value of the yen with respect to the dollar.

They agreed to pursue vigorous deregulation measures’ to encourage private sector growth. Second, they agreed to loosen monetary policy and liberalise financial markets, both with a view to ensuring that the yen ‘fully reflects the strength of the Japanese economy. They were compelled to reduce the government deficit, thereby reducing the economic size of the state.

Played an economic strategy was to encourage banks to lend enormous amounts of money, particularly for the purchase of housing, so that the economy continued to grow despite an appreciation of the yen and a reduction in government spending.

Of policies that had been pursued since the early 17/ large deficits, leading the Bank of Japan to worry that it large deficits, leading the Bank of Japan to worry that i could no longer underwrite the full quantity of outstanding government bonds.

Foreign Exchange Law of 1980 removed most capital controls, allowing Japanese residents | to invest internationally without government authorization

Restrictions on the size and term of deposits that could earn market-determined interest rates were gradually removed.

Japanese household debt rose from 52 per cent of GDP in 1985 to 70 per cent of GDP in 1990, as government policy eroded cultural norms against borrowing money.1

M3, a broad measure of the money supply, grew by a total of 141 per cent between 1980 and 1990; for comparison, between 1990 and 2010, M3 grew by only 40 per cent.12

As a result of low interest rates, safe assets were unappealing: in 1987, Japanese treasury bills were yielding only 2.4 per cent,

That time the lowest in their post-war history.!s Instead, investors piled into land and stocks.

The older generation, who generally had the most money to invest.14 Since Japan was one of the world’s most densely populated countries, land also had scarcity value. Landholders were often very reluctant to sell at a loss, so the nominal price of land rarely fell, perpetuating the belief that it was an extremely safe asset.

Apparent safety did not preclude the possibility of abnormal returns: there were substantial land price booms in 1961, 1974 and 1980, each of which was associated with a loosening of monetary policy. But only the 1974 boom was followed by a fall in nominal prices,

### Causes

## WHEELER-DEALERS: THE BRITISH WHEELER-DEALERS THE ROARING TWENTIES AND THE WALL STREET CRASH

## BLOWING BUBBLES FOR POLITICAL PURPOSES: JAPAN IN THE 1980S THE DOT-COM BUBBLE ‘NO MORE BOOM AND BUST’: THE SUBPRIME BUBBLE

## CASINO CAPITALISM WITH CHINESE CHARACTERISTICS

## PREDICTING BUBBLES