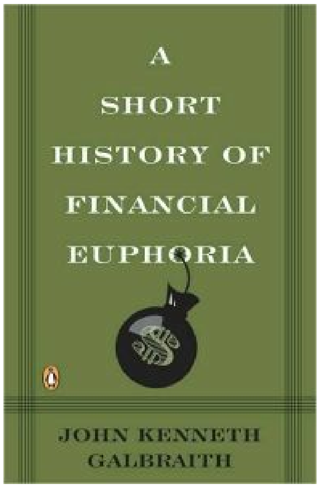

Book A Short History of Financial Euphoria

John Kenneth Galbraith
Penguin, 1994

Recommendation

John Kenneth Galbraith's short, literary book on financial speculation and the inevitability of subsequent economic catastrophe contends that devastating financial collapse is built into the free-enterprise system – an idea as intriguing today as it was when this book debuted in the mid-1990s. The late famous economist ended this treatise with a chilling question: "When will come the next great speculative episode and in what venue will it recur?" Everyone now knows the answer to that question all too well. Alarmingly, according to Galbraith, the travails that capitalist economies are now grimly experiencing will recur over and over. *BooksInShort* suggests that anyone who wants to understand the kinks in the system – and human nature – that will continue to lead to hugely devastating, economic train wrecks should read Galbraith's book.

Take-Aways

- Financial collapses are built into the free-enterprise system.
- As such, they are entirely predictable, yet most people never see them coming.
- Collapses always revolve around speculation gone haywire.
- Nevertheless, inside "experts" inevitably claim that complex external factors are responsible for markets collapses.
- Early debacles where that happened include the Dutch tulipomania, the South Sea Company's stock failure and the Great Depression.
- Financial speculation is impossible to regulate or control.
- Supposed financial innovations are seldom really new.
- Great wealth does not necessarily connote deep wisdom or financial legerdemain, though many rich people and most of the public think that it does.
- Many people intimately involved with money routinely make huge financial management mistakes.
- When public enthusiasm overflows for a hot investment or experts tout some great moneymaking opportunity, wise people will exercise extreme caution.

Summary

The Inevitability of Financial Disaster

Financial collapse is perhaps the most presumptive component of the free-enterprise (previously termed "capitalist") system. Such economic breakdowns are certain to recur for clear reasons that never change. People and institutions want a quick way to build wealth. Those who have wealth, or easily accumulate it, consider themselves – and promote themselves as – financially astute and wise. Those who lack wealth assume that such self-aggrandizing assessments are valid. This sets the scene and establishes the characters for inglorious events to come.

> "Not only fools but quite a lot of other people are recurrently separated from their money in the moment of speculative euphoria."

How the drama plays out never varies. In concert, enlightened fiscal savants begin a bidding war for some asset, often securities or land. Prices for that asset naturally skyrocket, thus providing tangible evidence of the speculators' financial perspicacity. The speculation mushrooms with heady momentum. Financial soothsayers portend that a "new price-enhancing circumstance is in control" so the asset's value will miraculously always keep increasing.

> "Given the nature of the euphoric mood and the vested interest therein, the critic must wait until after the crash for any approval, not to say applause."

Investors make a big financial and psychological investment in this "speculative euphoria." How could they not? Many of them benefit from a sudden, huge increase in wealth, which they assume is due to their superior understanding. Big players, assuring themselves of their own superb insights, continue to buy, forcing prices higher. "All people are most credulous when they are most happy," wisely observed Walter Bagehot, one of *The Economist*'s first editors. Even the first few astute analysts who see the house of cards for what it is continue to play the game, betting they will be able to get out before it collapses. Some do. Most don't.

> "In a world where for many the acquisition of money is difficult and the resulting sums palpably insufficient, the possession of it in large amounts seems a miracle."

At some point, of course, mass disillusion takes over. What was rocketing skyward so gloriously suddenly plummets back to earth. Investors rush for the exit before the inevitable crash. Many scramble to get out with their money intact, but most are injured. The landing is always exceptionally hard: no wheels, engines aflame and broken bodies all over the tarmac. Perpetually, the people who caused the disaster always blame it on complex outside factors and preserve their own cherished reputations. The marketplace throws a few of the most felonious speculators to the wolves. Like the majority of big money players, the financial markets remain sacrosanct, indeed, inherently without fault. Of course, they are not perfect. Ruinous, mounting speculation always has been an indelible component of financial markets and always will be. Yet few will admit it. The market is supposedly neutral, not subject to intrinsic mistakes. On Wall Street, this is a matter of standard belief. Questioning it is heresy.

> "Speculation buys up, in a very practical way, the intelligence of those involved."

Thus, the never-changing ending: Many lose everything. Yet, financial memories are remarkably short. Another speculative run inevitably emerges in a few years or, at most, a few decades. Gullible masses line up to throw money away on the next big thing. When it comes to money, people never learn. These duplicating cycles of madness are almost comically ironic. The lessons are crystal clear, but sadly, they repeat themselves throughout history. Why don't people learn about the dangers of speculation and the inevitable crash? A few lone voices always warn of investment debacles in advance, but no one listens. Following Wall Street's lead, the public sees such Cassandras as malcontents or blockheads who don't understand the magic of profit-making investments.

> "There can be few fields of human endeavor in which history counts for so little as in the world of finance."

Banker Paul M. Warburg, a founder of the U.S. Federal Reserve System, spoke out in 1929 against unlimited financial gambling. He foresaw collapse and disastrous depression. The public reviled Warburg. Some claimed, with a tinge of anti-Semitism, that he was "sandbagging American prosperity." When respected statistics expert Roger Babson also warned of the coming crash, he came under even worse attack. *Barron's* magazine said no one should "take him seriously."

> "There is nothing in economic life so willfully misunderstood as the great speculative episode."

Every economic downdraft plays out the same way. Initial investors tout the current speculation as splendid and original, thus justifying the situation that is bringing them great profits. The big financial institutions, benefiting from the new gravy train, avidly promote speculation. The public, spurred by these euphoric investors, ignores or vilifies those who warn about the inevitable fall. Then, the bubble bursts. Somehow, few see it coming. Afterward, a few token guilty parties end up in jail. But no one questions "the speculation itself or the aberrant optimism...behind it." People ignore self-evident reality, although it is right in front of them.

Common Causes

Speculative euphoric episodes share some common traits. The first is short-term fiscal memory. When Wall Street experts portray the latest speculation as some type of startling new find, some big shift in economics, they render previous experience archaic and meaningless. However, the truth is otherwise. The hot innovation always turns out to be some minor variation on the standard model, involving, "in one form or another, the creation of debt secured in greater or lesser adequacy by real assets." In short, it is not special at all.

> "In the last century the speculative imagination was at work in its most ardent form in the United States."

The second shared factor is the fallacious linkage between wealth and brilliant intellect. In the free-enterprise world, money is the accolade of a life well lived. The more you have, the smarter you must be. Those who doubt this truth are seen as grossly misinformed or lacking comprehension of how money works. If having wealth clearly establishes superior credentials, then only the best of the best must lead giant financial institutions. The public and these individuals themselves believe they can do no wrong. Everyone must defer to them and their speculative ventures. Only after a crash does their supposed special intelligence turn out to be specious. Note these historic events:

Tulipomania

The first major, modern world financial frenzy took place in Holland in the 1630s. Because it involved the value of tulips, it became known as the Tulipomania. Grown in the East, tulips first came to Western Europe in the mid-1500s. A significant shipment arrived in Antwerp from Turkey in 1562. People fell crazily in love with the rare, beautiful blooms. Over the course of a few decades, prices soared. By the 1630s, brokers and agents were buying and selling tulip bulbs in the major stock exchanges in Amsterdam and lesser cities. A single precious bulb came to be worth the equivalent of $25,000 to $50,000.

> "The euphoric episode is protected and sustained by the will of those who are involved, in order to justify the circumstances that are making them rich."

Otherwise sane, sound Dutch citizens sold their property to buy tulips. With supplies constantly short, the price kept climbing. The inevitable crash hit in 1637. Led by "the wise and the nervous," people fled the market. Panic set in; prices plunged. Merchants who were heavily invested in tulips became quickly impoverished. The courts refused to honor tulip contracts, viewing the whole matter as a giant gambling enterprise. Depression seized Holland, but the flowers remained. Ironically, the country is now famous for its beautiful fields of tulips.

The Bubble Act

In 1711, Robert Hartley, Earl of Oxford, and legal document copyist John Blunt formed the South Sea Company, which had a charter to retire English government debt by issuing stock. It held exclusive trading rights in the Americas, as guaranteed by the British crown. Awkwardly, Spain owned those same trade rights, but it eventually allowed the South Sea Company to make one voyage a year to the New World. Despite the unpropitious prospect of pursuing riches by sailing only once annually on a trading mission to an unknown continent, investors, including members of the aristocracy and members of the public, quickly lined up for shares in the new enterprise.

> "Recurrent descent into insanity is not a wholly attractive feature of capitalism."

The stock price, which was £128 in January of 1720, climbed to £1,000 by late summer. Investors quickly became astoundingly rich. Soon, other new ventures tried to horn in on the speculative action, including a "perpetual motion" company and a business whose principals planned to change quicksilver into "fine metal." One firm's proponents claimed that it would carry "on an undertaking of great advantage, but nobody to know what it is." In 1720, to prohibit such speculative ventures and to protect South Sea's investment, Parliament passed the Bubble Act – however, the air was already hissing loudly out of the balloon.

> "The only remedy...is an enhanced skepticism that would resolutely associate too evident optimism with probable foolishness and that would not associate intelligence with the acquisition, the deployment or, for that matter, the administration of large sums of money."

By December 1720, South Sea Company stock fell to £124. Angry citizens put forth petitions to wreak vengeance on its directors. Predictably, no one faulted the financial system itself. Author Charles Mackay added, "Nobody blamed the credulity and avarice of the people – the degrading lust of gain...or the infatuation which had made the multitude run their heads with such frantic eagerness into the net held out for them by scheming projectors. These things were never mentioned." They never are.

Speculation – American Style

Speculation took hold early in the life of the American colonies. Southern colonies issued trading notes based on tobacco. The colonial government paid its debts with paper notes, not gold or silver. Its hard assets seldom matched the value of its outstanding chits. Often, panicked citizens would launch runs on the currency, only to learn to their dismay that their notes were practically worthless. This farcical pattern repeated itself, over and over, after the colonies won independence. In 1837, speculation on land in the West and other investments led to a major real estate crash and an extended depression. Another panic took place in 1873. Banks closed or "suspended payments in hard coin." When the same thing occurred again in 1907, legendary banker J.P. Morgan came to the rescue. He helped to line up funding sources to bail out troubled banks. Should Americans worry about the nation's constant boom-and-bust? Famed economist Joseph Schumpeter claimed "recurrent mania" was an ordinary feature of economic life. Then came 1929.

The Great Depression

The Roaring Twenties seemed like an era of boundless optimism. The investment opportunities of the time seemed almost magical to the general population. The Florida real estate boom in 1924 and 1925 was typical. People could buy home plots with only 10% cash down. As prices doubled in weeks, Florida became synonymous with the American "get rich quick" fantasy. In the inevitable crash, in 1926, investors lost everything. Despite the Florida debacle, the boom mentality prevailed throughout the U.S. To temper things, the Federal Reserve Board declared that it might constrict interest rates. This slightly dampened the market. Charles E. Mitchell, president of National City Bank, said his company would lend money to counter the effects of the Federal Reserve. The market bounced back. However, as with any speculative episode, the handwriting was on the wall for all to see. Of course, few were able to see it.

> "There is the possibility, even the likelihood, of self-approving and extravagantly error-prone behavior on the part of those closely associated with money. Let that also be the continuing lesson of this essay."

Stock prices on Wall Street were climbing constantly. In the belief that they would continue to ascend, investors feverishly bought more shares, running prices up even further. Many investors made their purchases on a 10% margin, with interest rates from 7% to 12% (and, once, 15%). By autumn of 1929, things seemed particularly blissful for the euphoric investor class. "Stock prices have reached what looks like a permanently high plateau," said famous Yale economist Irving Fisher. Of course, he was all wet. Stock prices began to tumble on October 21 and went into free-fall on October 29, "the most devastating day in the history of the Exchange." The brutal market crash led to the global Great Depression, which was so severe that investors paid heed much longer than normal to the dangers of speculation. But by the middle of the 20th century, fiscal recall again began to short-circuit. Small booms took place in 1954 and 1955. Like clockwork, other speculative episodes popped up during the following decades.

What's the Answer?

Can anything be done to end speculative bubbles and their subsequent cataclysmic booms-and-busts? Probably not much. No government authority can outlaw fiscal naïveté or "mass euphoria," but if someone excitedly offers you a fabulous, hot, moneymaking opportunity, well, proceed with great caution. It would be immensely helpful if people could somehow develop a healthy skepticism about the supposed brilliance of anyone who possesses lots of money. People should further expect that such financially blessed individuals would almost surely make a hash of investing their funds for them (and should exit rapidly if some expert claims magic investment know-how and reaches for their wallets). Are people likely to gain such helpful awareness and knowledge? Not if history is any judge.

About the Author

World-famous economist **John Kenneth Galbraith** taught at Harvard and Princeton, and wrote more than 40 books. He served as U.S. Ambassador to India for President John F. Kennedy. Galbraith died in 2006.