BUBBLES, BOOMS, AND BUSTS

The Rise and Fall of Financial Assets

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

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[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 FDIC.

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 they 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.

Contents

Preface v

Introduction–The Holland Tulip Mania of 1636–1637 xix

Chapter 1

THE NATURE OF MANIAS, BUBBLES, AND CRASHES 1

Introduction; The Human Element; The Rise of Manias and Bubbles; Fueling the Boom; Wealth and Inflation

Asset Growth vs. Wealth: Cause and Effect?; Inflation

Speculations, Bootstraps and Swindles; The Rationality of Investors?; The Rationality of Bankers and Experts?

Rationality of Bankers?; Rationality of Experts?

Monetary Policy and the Federal Reserve System; Fiscal Policy and Taxes

Tax Policies

Income Tax; Estate Tax; The Alternative Minimum Tax

Income Tax Brackets and Budget Deficits; Capital Gains

Social Security and Medicare

Inequality

Why Inequality Persists and Expands

Inequality of Wealth in the United States

Debt

Us Federal Debt; State and Municipal Debt; Household and Mortgage Debt; The Dollar; Bankruptcies; World Debt

Deposit Insurance; Regulation, Deregulation and No Regulation; Pension Plans

Corporate Pensions

Defined Benefit Plans; Defined Contribution Plans

The Public Sector

The Valuation of Common Stocks; Internal Feedback and Endogenous Risk;
When the Bubble Pops; Notes

Chapter 2
A SHORT HISTORY OF BOOMS, BUBBLES, AND BUSTS 117

The New World
South Seas Bubble; John Law's Mississippi Company
Florida Land Boom of the 1920s
The Rise; The Fall; Underlying Causes
The Roaring 20s STOCK MARKET
***The Real Economic Boom of the 1920s; The Stock Market of the 1920*s;**
The Crash of ***1929***
The Great Depression of the 1930s; The Savings and Loan Scandal of the 1980s
The Original Problem; Deregulation and No Regulation; How Mr. Reagan Made a Bad
Problem Worse; The False Spring of 1983; the "Go-Go" Period;
Fraud and Misconduct; The Aftermath
The Bull Market of 1982–1995; The Crash of 1987; The dot.com Mania
Boom and Euphoria; Greenspan and the Role of the Federal Reserve;
Bursting of the Bubble; Merrill-lynch Is Bullish On America
Other Bubbles and Swindles of the Late 1990s and 2000s
Adelphia; Rogue Traders At Banks
Barings Bank; Allied Irish Banks; Societe Generale
Enron; Long-term Capital Management; Albania's Ponzi Schemes;
Corporate and Accounting Scandals
The Sub-prime Real Estate Boom 2001–2007
Origin of the Boom; Expansion of the Boom; Residences as Atms;
The Punctured Bubble; Mortgage-backed Securities; Government Response
to the Punctured Bubble; International Mortgage Debt; The Hidden Time Bomb
Japan and East Asia
Japan 1970–2007
Background; The Japanese Boom and Bubble; Collapse of the Japanese Bubble
East Asia
The Oil Bubble; The Next Bubble; Notes

Abbreviations 267