

Bubbles in our future? Certainly!

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Bubbles in our future? Certainly! | Last stand: this photograph became an icon of the crisis, and shows bankers attending an emergency meeting at the London office of Lehman Brothers

Have we learned the lessons of the 2008 crisis? Could a new bubble form and burst? This chapter from Donald Johnston's 2017 book, *Missing the Tide: Global Governments in Retreat*, provides food for thought.

In October 2008, Alan Greenspan called the credit crisis caused by a housing bubble a tsunami that would only occur once a century. Not long ago he could have made a similar comment about asset bubbles, which historically were decades and even a century apart.

The derivative fiasco

Yet we have witnessed two bubbles within a decade: the dot-com bubble at the turn of the century and then the American housing price bubble, which had global economic consequences because of the international marketing of derivatives secured on overvalued assets, notably the subprime mortgages of American homeowners. The credit crisis Greenspan spoke about was not a direct product of an asset bubble but rather the impact on lenders who had bet on such derivatives for better rates of return during a period of very low interest yields on conservative debt instruments. Japanese banks suffered in the same way in the 1990s after they loaned massive amounts of capital secured on highly inflated real estate values. Fortunately, those Japanese debt instruments were not engineered

into derivatives and marketed around the world. When lenders are faced with writing off massive amounts of such bad debts, their capacity to meet obligatory reserve requirements and the borrowing demands of others, such as small- and medium-sized businesses, dries up. Economic activity is stifled and jobs quickly disappear. All enterprises dependent on credit suffer, so the economy-wide knock-on effect is dramatic.

The more recent economic downturn in Spain was similar to that in Japan, with the accumulation of non-performing bank loans in the real estate sector. The capacity to lend disappeared and the lack of credit facilities carried economy-wide consequences. The tsunami to which Greenspan referred was of a different order of magnitude because it was rooted in sophisticated financial engineering that created derivative instruments secured largely on overvalued subprime mortgages of American homeowners and widely marketed both domestically and internationally.

Globalisation of financial markets carries serious risks because the seamless integration of these markets enables contagion to find a convenient path across continents and the globe. Some economies, such as the Korean one, escaped much of the damage from the subprime crisis because their financial markets were not as integrated internationally as many others. Greenspan resisted the regulation of financial derivatives and considered that they had made the banking system more resilient as evidenced in part by the fact that they remained robust despite the collapse of the dot.com bubble. In remarks to the Futures Industry Association on 19 March 1999, he commented on derivatives in the mid-1990s: “The reason that growth has continued despite adversity, or perhaps because of it, is that these new financial instruments are an increasingly important vehicle for unbundling risks. These instruments enhance the ability to differentiate risk and allocate it to those investors most able and willing to take it.” He believed that the burden of regulating these instruments would reduce their attractiveness.

However, in 2008, as the economic consequences of these widely held derivatives became evident, he had this to say to the House Committee on Oversight and Government Reform, as I noted in Chapter 6 [see reference]: “Those of us who have looked to the self-interest of lending institutions to protect shareholders’ equity, myself included, are in a state of shocked disbelief.”

Is an unintended result of the derivative market the creation of more and more risk by those who sell such instruments knowing they will not be holding the risk themselves? Would they have had more incentive to confirm the creditworthiness and asset values of the original borrowers had at least some of that risk remained on their balance sheets? Is that not an important element of what we witnessed with the subprime crisis? Creators and sellers of such derivative instruments should continue as guarantors, jointly and severally, of the underlying value, just as endorsers of a cheque or bill of exchange do.

Ottoman tulips and historical precedents

Returning to the question of bubbles, how does one foresee that there is a bubble destined to collapse? And is there some commonality between historical bubbles from which lessons can be drawn that raise red flags for investors?

Consider the tulip bubble of the 17th century. The Ottoman Empire supplied the first exotic tulip bulbs to the Netherlands at the end of the sixteenth century. The Dutch appetite for exotic tulips was the foundation for economic history's first infamous bubble. At the height of the bubble, we are told that an Amsterdam man was offered, but refused, 3,000 guilders—the annual income of a wealthy merchant—for a remarkable tulip bulb called *Semper Augustus*. To put it into perspective, shortly thereafter Rembrandt received about one half as much for painting “The Night Watch”, which remains a highlight of the Rijksmuseum in Amsterdam.

It was reported in *The Economist* of 4 October 2013 that in the 1630s a sailor was thrown in a Dutch jail for eating what he thought was an onion. It was in fact a tulip bulb. Apparently the value of that supposed onion equalled the cost of feeding an entire ship's crew for a year. This craze ended—the bubble burst—with the collapse of the tulip market in 1636–37.

The next major bubbles, John Law's Mississippi Bubble in France and the South Sea Bubble, occurred almost a century later.

Beware greater fools

We have witnessed how the theory of the “greater fool” plays out in bubble creation, with each investor trapped between the emotions of greed and fear and thinking there will always be a greater fool to take his or her position. For example, the great Sir Isaac Newton was caught in the South Sea bubble. An early investor, he sensed that a crash was ahead and became fearful; he bailed out, allegedly realising a then-handsome profit of 7,000 pounds. As he watched the stock continue to rise, greed apparently overtook Newton and he repurchased stock, ultimately losing some 20,000 pounds as the bubble collapsed. I cite the example of Newton to illustrate how irrational exuberance can take over the most rational of minds.

Identifying bubbles: art or science?

There are strong analogies between the dot-com bubble of recent years and the South Sea bubble, and for that matter the stock market crash of 1929 where in two months the market lost 40% of its value and by the end of the crash three years later was down nearly 90% from its 1929 high.

Some economists say that a bubble occurs when the price of an asset, such as shares, exceeds the intrinsic underlying value of the company. Some define intrinsic as the value of an object, good, or service contained in the item itself. I

find this an area of considerable difficulty when one talks, for example, of fundamentals such as the price-earning ratios in a particular sector as a yardstick of values. But often the shares rise far beyond that in anticipation of future earnings, which may never be realised.

Look at the situation with the dot-com phenomenon. In many cases there were no earnings at all, just irrational expectations. In some instances those anticipations may turn out to have been a great investment opportunity. Think back to the initial scepticism about the price of Google shares, which were issued in 2004 at \$85 and hit \$700 in late 2007.

As a contemporary example, gold prices have been very volatile since 2000, rising to about \$1,900 per ounce and then falling back to less than \$1,100 before achieving a modest recovery. In 2001 gold was less than \$300 per ounce. Is this not a bubble in line with the tulip craze of the 1600s? What is the intrinsic value of gold today, beyond its use in commercial metal applications? At least a tulip bulb is edible, as the imprisoned Dutch sailor proved.

Many American workers and their families who had not seen meaningful income increases for many years probably relied on “bubble equity” in then-current home values to finance their children’s education or purchase consumer products that they could otherwise not afford. There was certainly a strong incentive to do so.

I conclude that most bubbles are identifiable only with hindsight. Most economists failed to predict the collapse of the housing market in the United States that began in the summer of 2006. I referred in chapter 6 to Larry Summers’ assertion in January of 2006 that there was no housing bubble in the United States. Because greed is a basic component of human nature I believe there will always be irrational bubbles chased by investors trying to catch them as they inflate, knowing full well that collapse may lie ahead but hoping it comes after they have made a profitable and safe retreat by benefiting from the greed of the greater fool.

Excerpt adapted especially for the OECD Observer from Donald J. Johnston’s 2017 book, Missing the Tide: Global Governments in Retreat, published by McGill-Queen’s University Press. Readers can order their copy at www.mqup.ca/missing-the-tide-products-9780773549715.php?page_id=73&

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