bubbles in history

A bubble may be defined loosely as a sharp rise in price of an asset or a range of assets in a continuous process, with the initial rise generating expectations of further rises and attracting new buyers – generally speculators interested in profits from trading in the asset rather than its use or earning capacity. The rise is usually followed by a reversal of expectations and a sharp decline in price often resulting in financial crisis. A boom is a more extended and gentler rise in prices, production and profits than a bubble, and may be followed by crisis, sometimes taking the form of a crash (or panic) or alternatively by a gentle subsidence of the boom without crisis.

Bubbles have existed historically, at least in the eyes of contemporary observers, as well as booms so intense and excited that they have been called 'manias'. The most notable bubbles were the Mississippi bubble in Paris in 1719–20, set in motion by John Law, founder of the *Banque Générale* and the *Banque Royale*, and the contemporaneous and related South Sea bubble in London. Most famous of the manias were the Tulip mania in Holland in 1636, and the Railway mania in England in 1846–7. It is sometimes debated whether a particular sharp rise and fall in prices, such as the German hyperinflation from 1920 to 1923, or the rise and fall in commodity and share prices in London and New York in 1919–21, the rise of gold of $850 an ounce in 1982 and its subsequent fall to the $350 level, were or were not bubbles. Some theorists go further and question whether bubbles are possible with rational markets, which they assume exist (see e.g. Flood and Garber, 1980).

Rational expectations theory holds that prices are formed within the limits of available information by market participants using standard economic models appropriate to the circumstances. As such, it is claimed, market prices cannot diverge from fundamental values unless the information proves to have been widely wrong. The theoretical literature uses the assumption of the market having one mind and one purpose, whereas it is observed historically that market participants are often moved by different purposes, operate with different wealth and information and calculate within different time horizons. In early railway investment, for example, initial investors were persons doing business along the rights of way who sought benefits from the railroad for their other concerns. They were followed by a second group of investors interested in the profits the railroad would earn, and by a third group, made up of speculators who, seeing the rise in the railroad's shares, borrowed money or paid for the initial instalments with no intention of completing the purchase, to make a profit on resale.

The objects of speculation resulting in bubbles or booms and ending in numerous cases, but not all, in financial crisis, change from time to time and include commodities, domestic bonds, domestic shares, foreign bonds, foreign shares, urban and suburban real estate, rural land, leisure homes, shopping centres, Real Estate Investment Trusts, 747 aircraft, supertankers, so-called 'collectibles' such as paintings, jewellery, stamps, coins, antiques etc. and, most recently, syndicated bank loans to developing countries. Within these relatively broad categories, speculation may fix on

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particular objects – insurance shares, South American mining stocks, cotton-growing land, Paris real estate, Post-Impressionist art, and the like.

At the time of writing, the theoretical literature has yet to converge on an agreed definition of bubbles, and on whether they are possible. Virtually the same authors who could not reject the no-bubbles hypothesis in the German inflation of 1923 one year, managed to do so a year later (Flood and Garber, 1980). Another pair of theorists has demonstrated mathematically that rational bubbles can exist after putting aside 'irrational bubbles' on the grounds not of their non-existence but of the difficulty of the mathematics involved (Blanchard and Watson, 1982).

Short of bubbles, manias and irrationality are periods of euphoria which produce positive feedback, price increases greater than justified by market fundamentals, and booms of such dimensions as to threaten financial crisis, with possibilities of a crash or panic. Minsky (1982a, 1982b) has discussed how after an exogenous change in economic circumstances has altered profit opportunities and expectations, bank lending can become increasingly lax by rigorous standards. Critical exception has been taken to his taxonomy dividing bank lending into hedge finance, to be repaid out of anticipated cash flows; speculative finance, requiring later refinancing because the term of the loan is less than the project's payoff; and Ponzi finance, in which the borrower expects to pay off his loan with the proceeds of sale of an asset. It is objected especially that Carlo Ponzi was a swindler and that many loans of the third type, for example those to finance construction, are entirely legitimate (Flemming, Goldsmith and Melitz, 1982). Nonetheless, the suggestion that lending standards grow more lax during a boom and that the banking system on that account becomes more fragile has strong historical support. It is attested, and the contrary rational-expectations view of financial markets is falsified, by the experience of such a money and capital market as London having successive booms, followed by crisis, the latter in 1810, 1819, 1825, 1836, 1847, 1857, 1866, 1890, 1900, 1921 – a powerful record of failing to learn from experience (Kindleberger, 1978).

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See Also **tulipmania.**

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