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**EVERYTHING IS NOT A BUBBLE**

*When The Hurley Burley’s Done*

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**Introduction**

Many books written after a financial or economic crisis including the collapse of a major bubble seem primarily designed to shock and scare the reader with respect to the just past economic catastrophe and the one looming just around the corner. Indeed after an economic crisis such as the recent Great Recession there seems to have been a bubble in books about bubbles as each author competes with other experts in explaining how it happened, how that particular author saw it coming and how the next one can be avoided.

In addition the popularity of the word appears to result in every economic and financial problem becoming a bubble including the Euro Crisis centered in Greece but also involving Ireland, Portugal, Spain, Italy and even France. It is in this way that many financial gurus can identify several bubbles affecting the US or global economy that will come together to create a massive and coordinated bubble and crash that only they can help investors and policy makers avoid.

However, from the perspective of analyzing bubbles generally or a specific bubble such as the one leading to the Great Recession, there are several problems with this general labeling and analysis especially if it is to be used as an investment or regulatory strategy.

Some authors justify this general labeling by incorrectly stating there is no accepted definition for a bubble or that the definitions that do exist are so vague as to defy concrete analysis. Thus they feel free to use the word indiscriminately and can therefore define situations that are not bubbles as bubbles increasing the hype of their message while actually decreasing its analytical validity. The accepted definition of a bubble is when the price of an asset rises rapidly to a significant level above it basic economic value such as the price of a house compared to its discounted rental value. At some point this differential becomes unsustainable and the bubble collapses. The authors in this volume use this definition in their analysis of bubbles and it is consistent with the one used by Professor Aliber in the current edition of the seminal work on bubbles, Manias, Panics and Crashes.

There are three important components to this definition. First a bubble concerns assets that are unique in some respect and limited in supply such as real estate with a Hudson River View or great art such as a Matisse painting. Things that can be produced are rarely bubbles since the rapid rise in prices will bring increased production as seen in the Rare Earths Chapter. At the same time there must be enough of the asset or related assets available such that when prices begin declining it affects the entire class such as Japanese urban real estate or dot.com stocks or impressionist paintings.

Second the price rise must be rapid, something that is captured in the analogized equation E = MP2 where the explosive aspect of the bubble when it pops is equal to the money flowing into the market for the assets times the acceleration in real prices. If it takes 72 years for the real price of the asset to rise 100% above the asset’s economic value, the price will only be rising above the asset’s economic value at 1% per year and is unlikely to attract the speculators critical to forming an asset bubble. On the other hand if its real price [nominal price rise less the CPI] rises 15% or more per year it will double its price in less than 5 years and will attract speculators who will accelerate the price rise and draw more money into the bubble increasing the negative impact on investor and speculator wealth when the crash finally occurs. Real prices are used because people need to feel they are getting wealthy as a result of the bubble. There is unlikely to be any money illusion if the CPI is also going up more than 15% a year.

Having the right statistics or price metrics is a thus key aspect in identifying a real bubble given that the cycle starts with an infusion of new cash into the market for the asset. So a bubble based investment strategy would be Cash to Investment back to Cash. Examining some famous stock market bubbles, the top of the US market bubble prior to the Great Depression was 1929 with the subsequent bottom in July 1932 but it did not regain that 1929 high until the peak of the defense related-conglomerate and nifty fifty boom of the 1960s and early 1970s. That bubble led to a new high in the Dow-Jones in January 1973 at 1022. It subsequently fell to a bottom in the subsequent crash at 570 in December 1974. It did not go over that 1973 high until 1983, reaching a new peak in January 2000 at 11,908 followed by another crash due to the dot.com bust.

We see in the first cycle that over a 41 year period the Dow went up by a factor of 26 times and in the second over a period of 26 years it went up twenty-one times. If we extend the analysis to the high of 14,280 in October 2007, it was 25 times over a 34-year period.

In any case financial bubbles involve asset prices. If there is no asset, then there is no bubble. Applying this criterion to bubbles some authors associate with US budget and trade deficits, there is in fact no bubble. This does not mean ballooning trade and budget deficits are not worrisome trends. These expanding deficits have implications for investment strategies and helped facilitate the housing and subprime mortgage bubbles. Indeed as noted in the Introduction Professor Aliber has directly linked the financial flows associated with several different countries’ trade and budget deficits to particular bubbles. Nevertheless they themselves are definitely not bubbles because there is no asset involved that is increasing rapidly in price.

If I build 50 houses during a five-year period at 10 houses a year and next year I build another 10 houses I have 60 houses and there is no bubble unless the prices for those houses rise dramatically creating an asset inflation. Similarly if I have a series of budget deficits or trade deficits I have just added to the national debt and the borrowing from foreigners. Since these obligations are all denominated in dollars and the price of one dollar does not change, there has been no change in price. Further from a US investor’s point of view there is no asset involved since the trade deficit is not an asset nor is the US budget deficit. Therefore there is no change in any asset price.

For the same reason from a US investor’s perspective there cannot be a dollar bubble because the price of a dollar is not rising or falling except compared to another currency or some benchmark commodity such as oil or gold.

This is not to say you cannot have a dollar bubble. You can. But you have to be a non-US investor and you have to be investing in US dollar assets such as US stocks or bonds. Indeed such a bubble occurred in Japan in the early 1980s after the US negotiated the Yen/Dollar Accord. US interest rates at that time were extremely high due to the Volker anti-inflation squeeze and this attracted investment by Japanese financial firms, especially big life insurance companies that due to the regulatory changes resulting from the Yen/dollar Accord were now permitted to invest in foreign currency assets. This dollar asset demand strengthened the dollar against the Yen creating foreign exchange gains for the insurers on top of the very high interest rates. Then in 1983 when US interest rates started falling there were capital gains on the bonds too. This combination of high interest rates, exchange gains and market appreciation attracted more Yen funds further strengthening the dollar and lowering rates that created more capital gains.

However, the very strong dollar hit US exporters extremely hard, especially firms such as Caterpillar, Boeing and GM and strong political pressures developed to counter the appreciating dollar weak yen environment leading to a collapse in the dollar bubble in 1985. Then as is not uncommon with a collapsing bubble the Japanese economic and policy reactions to the rapidly devalued dollar relative to the Yen established the preconditions needed for the Japanese real estate and stock market bubble that crashed in early 1990. This was because the investment funds that normally would have flowed out of Japan now turned inward seeking local investment opportunities. This is described in a paper “Foreign Firms in Japan’s Securities Industry in the 1980s and Post Bubble Economy,”[[1]](#footnote-1)

“Part of the bubble’s origin is found in excess liquidity after 1985 due to a combination of the trade surplius and the sharp yen appreciation after the Plaza Accord. The balooning surplus greatly increased the money supply as companies converted dollars to yen and the Bank of Japan permitted the increase to counter the deflationary effects of a strengthening yen (Ito, 1992). Further, as already noted, portfolio investors had stormed into foreign assets in the early 1980s in response to higher rates, also keeping the yen weak (Shinkai, 1987). Now they took billions in portfolio losses, and sought the safety of yen assets and hedges for their dollar investments. This created additional upward yen pressure. So excess liquidity found outlets in government bonds, real estate and stocks with investors primarily large corporations, financial institutions, and wealthy individuals. No longer having attractive overseas investments, excess savings chased domestic assets, driving up prices (Ito, 1992). For instance government bond trading which had amounted to about to 200 to 500 trillion yen between 1980 and 1984 jumped to 2,200 trillion in 1985 and peaked at 5,800 trillion in 1987 (Japan Securities Research Institute, 1994).

However, the supply of Japanese bonds, real estate and stocks were restricted. Historically, financial institutions had bought government bonds by direct placement and held them to maturity (Shinkai, 1987) which was why trading activity was rather limited. Similarly, people and companies did not sell real estate because taxes were too high (Ito, 1992) and prices always went up (Frankel, 1991 and Yamamura and Hanley, 1992). Finally, firms did not sell stock because the market over time has trended up and because of stable shareholder relationships (Zielinsky and Holloway, 1991). Further, over time the proportion owned by institutions had risen since they were generally buyers, not sellers. Thus, by the late 1980s, unlike the U.S. 70% of stock was held by companies and individuals for business purposes (Zielinsky and Holloway, 1991). …

 This environment would have forced prices up more than normally in any case. But as stock and real estate prices, they created a compounding effect and the engine for the sharp upward price spiral and the bubble. The increase in bond, real estate and stock prices caused investors to value companies based on these hidden real estate and financial assets, bidding up their shares (Frankel, 1991 and Ito, 1992). They then used stock gains to buy real estate, either selling shares or borrowing against appreciation. Profits and loans on appreciated real estate were used to buy stocks and bonds, ratcheting up both on a continuous interactive basis as the bubble became full blown. Since rising rices for bonds, stock, or real estate affect all holders, this extended well beyond the immediate buyers and sellers to all owners, lifting the economy’s borrowing capacity and paper wealth enormously. …

The first indication of possible weakness in this boom scenario given a change in supply/demand dynamics came with the fall in the Government Bond Market in June 1987. Here, unique features of the market combined with the loose money policy to promote ramping by a syndicate of banks and securities houses. As money expanded and interest fell, money poured in during the first half of 1987, and the “benchmark’s” price rose sharply. By June, the yield approached 2%. It was then rumored the reason for the rapid rise was a syndicate had cornered the limited supply of benchmark bonds. Other dealers caught short complained and the MOF moved quickly, unilaterally expanding the issue and eliminating the corner. The ensuing collapse, though, showed what could happen when the pressure of too much money chasing a restricted asset supply was eased. So while stocks recovered after the October 1987 crash, the bond market did not because the institutional dynamics restricting supply had been permanently altered. …

Since bonds did not recover but but stocks did with the Nikkei Index rising from about 18,000 in 1987 to 38,000 at the end of 1989 (Japan Securities Institute, 1994), the interactive upward price ratcheting in stock and real estate resumed with the speculative money in bonds adding to the pool.”

Something similar, however, happened to stocks and real estate when the MOF in 1988 allowed the development of a futures market that could essentially create stock out of air while at the same time restricting bank lending on real estate and revising the 1975 real estate pricing law (Rapp, 1999). The decrease in available leverage for real estate combined with the de facto increased supply of stocks to dramatically reduce upward price pressures and then contributed to a downward acceleration. Many banks and insurance companies lost their hidden reserves plus there were losses on loans secured by real estate and stock. Over two trillion dollars in market value evaporated, completing a classic boom and bust bubble from which Japan has not yet fully recovered (Rapp, 1999).

At the same time it illustrates several important analytical benchmarks. A bubble occurs from the standpoint of some investor or speculator. Here the dollar asset bubble occurred from the standpoint of Japanese investors. When the dollar collapsed dollar investors did not lose but Japanese insurance companies did which is why in the subsequent boom they funneled money into yen assets. However, in the yen boom and bust both Japanese and foreign investors were active, though many of the latter made money betting against it (Rapp, 1999).

If one applies this type of analysis to a US based investor prior to and after the 2008 crash, one can examine whether there was a bubble in the dollar against some other currency’s investor or against some other currency from a US perspective. Was there for example a bubble in the dollar from the perspective of the Chinese and Japanese governments even though those governments have historically purchased dollars to keep their currencies weak so their export industries will continue to generate employment.

Indeed many predict that the triggering event for a coming crisis will be when these governments get tired of buying US bonds because they predict this dollar accumulation cannot go forever. Many well-known analysts argue this unwillingness to buy US bonds will trigger a very sharp rise in interest rates that the Fed will be unable to counter and this will bring about a bubble crisis as the dollar devalues.

However, there are many things wrong with this scenario. In the case of Japan, for example, this accumulation has been occurring since the mid-1970 or more than 35 years. Therefore it is not clear why the Japanese MOF will suddenly change its mind. It is also true that in addition to the Japanese, the Chinese, the Koreans and Taiwanese have been pursuing the same neo-Mercantilist job creation strategy for several years. If they were to begin selling their dollar assets and exchanging them for another currency, though, such as the Euro or the Yen then those currencies would appreciate against the dollar and US exports would rise stimulating US employment and the US economy. Indeed the Japanese have accused the Chinese of buying Japanese bonds with the predatory purpose of weakening Japanese competitiveness in key industries such as automobiles and electronics.

Further as imports are only a small part of the US economy any inflationary impact would be modest. Finally any increase in bond market interest the Fed could easily counter through expanding its balance sheet, though this might not be necessary given the expansion in exports and reduction in imports, all of which would tend to stabilize the dollar at a new and more competitive level.

In retrospect of course we know the 2008-2009 crisis had nothing to do with the Japanese or Chinese refusing to accept dollars. Thus the Fed never had to raise interest rates to protect the dollar and it is not clear given the actions they did take that they would have. Rather this bubble and bust had everything to do with the subprime mortgage crisis where dollar trillions of over-priced securitized mortgage loans defaulted causing the bankruptcy of several major as well as minor financial institutions and a global financial meltdown with aftershocks continuing into 2012.

The housing bubble developed because people’s incomes were not rising in proportion to the rise in housing prices and when interest rates rose too they could not meet the rising monthly service costs. Therefore they borrowed to fill the gap. When this was no longer possible housing prices began to peak, defaults increased and the crash started and then expanded to the securitized mortgage backed securities market that was itself financed by a highly leveraged global financial system. Since some investment banks and hedge funds were leveraged over 30 to one (see Chapter 7 on Structured Investment Vehicles) even small changes in such asset values proved disastrous.

Predicting this crisis, as some did, thus required not a focus on what the Chinese and Japanese were doing but a focus on US housing, CDOs and the activities of US financial institutions. Under this scenario after US housing prices peeked in August 2005 and began declining people could no longer refinance their homes to payoff credit card bills, fund their monthly mortgage payments, or increase consumption spending. As Aliber has explained Ponzi finance where interest can be covered through refinancing ended for many US consumers. Morgan Stanley estimated this took a trillion dollars out of US consumption. This development in turn triggered mortgage defaults and thus a decrease in the value of trillions of dollars in mortgage and credit card backed securities.

The collapse of the US housing market meant other economies built on similar economic structures such as Spain and Ireland would suffer similar fates. There would also be a dramatic fall in US consumption that had been financed by mortgages and credit cards. Yet the Bubble was not in consumer debt that had like the US government and trade deficits just grown. Rather it was in the securities backed by mortgage and credit card debt and then packaged by investment banks and sold to investors worldwide. In fact as Michael Lewis book the Big Short (Lewis, 2011) informs us some of these securitized assets were “designed to fail”. The issuance of these assets such as subprime mortgages, CDOs, and Credit Default Swaps grew rapidly but were over-priced relative to their true economic value.

Under this scenario as financial institutions came under pressure they would do what they always do in these situations, they would become more conservative, providing less and less business and consumer credit. This would in turn make the overall deflationary impact on the economy worse. It would lead to a collapse in stock prices for anything connected with homebuilding and the mortgage-backed securitization business including investment banks, commercial banks, specialized mortgage lenders, those providing credit default swaps [AIG], and mono bond insurers. Lewis (2011) does an excellent job of describing this development. These developments would of course make lenders even more conservative creating an adverse economic loop.

Given this set of facts a major recession was likely in response to which the Fed would lower interest rates dramatically and the Federal government along with other countries would begin aggressive fiscal stimulation. Under these conditions the Chinese and other neo-mercantilist countries would not stop buying US bonds because demand for their exports was going to drop significantly and they would want to maintain that export related employment. Again the bubble was thus not in the dollar but in housing and subprime mortgage backed securities. Everything related to these would collapse including bank stocks such as Countrywide or the mono-insurers of mortgage-backed debt or the writers of Credit Default Swaps such as AIG.

Conversely due to a combination of low interest rates and fiscal stimulus infrastructure would be expected to do well and did. An investment in a diversified portfolio of such stocks between the end of November 2008 and March 2009 would have yielded around 3 times one’s investment. Similarly concern with financial safety saw a large move into Treasuries further lowering market interest rates. In the Spring of 2007 when the housing bubble collapse signals were fairly apparent 10 year Treasuries were paying 5% compared to a yield of 3.4% by 2009 and even lower in 2012. Thus moving into Treasuries in 2007 would not only have protected an investor from the crash it would have yielded a nice return plus a capital gain, until the collapse in stock prices was over and one could then invest in a potentially sharp and lucrative upside recovery.

This is not to say investment recommendations in gold or the Euro would not have yielded positive results. Gold almost doubled between 2005 and 2010 and the Euro has been selling at a premium to the dollar. However, investing is all about percentages and a doubling of the gold price between 2005 and 2010 is only a 15% rate of return, hardly comparable with the bounce in infrastructure stocks. The Euro in turn during this period only rose 25% or an average of 5% per year or comparable to Treasuries and clearly with more risk as seen by its fall relative to the dollar by the summer of 2012. In fact if one did not see Greece coming, US based investors might be slightly down on a 2005 Euro investment.

Actually in terms of a foreign exchange play given a prescient assessment of the coming 2008 collapse as being housing and financial credit focused, a Yen investment would have been a more logical choice. This is because the Japanese for the last several years have not been manipulating their currency as the Chinese have. Rather the continued deflation in Japan has led the central bank to keep borrowing rates close to zero. This has created something known as the “carry trade” where hedge fund managers would borrow Yen and then invest in securities in other currencies with higher yields including US dollar securities. This use of borrowed Yen to buy dollar assets kept the Yen weak and in some cases gave hedge fund managers a negative cost of funds.

Given the expected drop in US dollar rates resulting from the housing bubble collapse scenario, though, the reasons for the carry trade would disappear and the Yen would subsequently strengthen. In addition a global recession would lower oil prices and the Yen is an anti-petro currency. Therefore given a projected asset backed securities collapse scenario a Yen appreciation was likely and this turned out to be a correct call. On balance gold appears to have been among the best of the various hedging options though it did not achieve the incredible multiples of those who shorted the subprime mortgage crisis [Big Short, Lewis, 2011]. Also gold prices as of July 2012 were down about 20% from their earlier peak.

It should also be recognized that gold’s annual economic demand depends on use in industry and jewelry. If it rises in price in a downturn, industrial users will try to use less and jewelry demand will switch to supply as the stock of gold jewelry is exchanged for cash. Thus, to know the top in the price of gold one needs to monitor whether there are long lines on 47th Street and its overseas equivalents to sell jewelry since the available gold stock accumulated since 5000BC will overwhelm demand. This is what happened in 1980.

Of course a bubble collapse of global consequences is not a good thing even if one saw it coming and took the logical protective steps just outlined or just because some capital product industries have benefitted from infrastructure investments. Local and state governments not only in the US but in other countries have been very badly hurt too, especially in education and healthcare. This is because these governments are heavily dependent on property taxes, sales tax and income tax revenues that all fell sharply at the same time that expenditures related to unemployment rose along with pension costs and unfunded benefits given layoffs and falling stock prices. This could be especially hard on communities that promised more than they could afford during the good times they thought would continue or that were sold toxic assets by investment bankers.

Therefore it is appropriate from a policy standpoint that governments understand and work to manage large financial bubbles. At the same time if one is going to manage bubbles it is critical that one understands them and is able to differentiate among the different types or when there is no bubble at all. This is not possible when one defines every dramatic rise in prices as a bubble along with every financial crisis. For example some commentators see the rise in CEO compensation relative to labor and middle management income as a bubble (Shiller, 2012) or collage tuitions with both leading to financial as well as social crises.

**Is There A Bubble In CEO Compensation Or College Tuition?**

Robert Shiller in his latest book, Finance and the Good Society (Shiller, 2012), argues that there is a Bubble in CEO compensation. Others have argued that the increasing cost of higher education is now a bubble that has been exacerbated by the recent financial debacle because state and local governments have cut back on their support, forcing public colleges to raise tuitions and students to take on more debt.

Few deny these are large and serious financial problems in the aggregate for the United States with significant societal consequences. The income and wealth differentials between the top 10% and even more the top 1.0% and 0.1% are increasing and the Occupy Wall Street movement and political polarization over tax rates for the wealthy show these have clearly become important social and political issues (Ferguson, 2012). Similarly debt loads for many students are becoming overwhelming and the rates of default especially for those attending profit-making institutions are rising. Over a trillion dollars in student debt is a burden on family formation and has forced many new graduates to return home while trying to find employment in a difficult job market. Yet are these situations Bubbles?

Applying the criteria used above the answer is no and they are examples of how the bubble word has been abused and can lead to a misleading impression of what is a bubble and the appropriate investment and/or policy response.

A bubble requires an asset that is tradable or at least interchangeable with similar assets in that class and where a rise in the price of related assets responds to increases in demand such as when all dotcom stocks went up together but where they will all also trend down together when the bubble bursts. Of course under the 13th Amendment to the US Constitution one cannot buy and sell human beings in the US as an asset. Yet one could argue that because CEO pay has steadily outpaced the CPI on the upside while workers and middle management income in real terms has remained relatively steady there is a CEO compensation bubble.[[2]](#footnote-2) Indeed some pay packages have been really outsized. However, though a CEO can leave to go to another firm for more money this can take weeks to accomplish not seconds as when selling a security. Further terminations do not seem to cause buyer’s distress.

Further the number of CEOs seems not only limited but also highly segmented especially for large public companies where the issue seems to be most visible and political. Among the international Fortune 1000 there are only 1000 CEOs and the pay for some such as in large Japanese firms appears to be totally unrelated to the compensation for American CEOs. Further when the CEO Merrill Lynch Stan O’Neal was fired his replacement John Thain’s package seemed equally rich. In addition the compensation in an industry such as steel appears unrelated to the compensation for CEOs in finance or autos.

This is not to say there cannot be bubbles in compensation but it appears to take place at lower levels such as freshly minted lawyers, MBAs and programmers who are hired at will or based on a standard employment contract rather than via the elaborately negotiated contracts for high paid CEOs. Since the recent financial collapse there have been numerous articles on how freshly minted lawyers even from top law schools are no longer guaranteed a spot at a top law firm while facing massive amounts of student loan debt. At the same time the ABA has reported that for those lucky enough to be hired by a top tier firm pay packages have remained relatively constant and have not yet collapsed. Thus the market seems to be working as supply exceeds demand. But there is no bursting of a law compensation bubble. Similarly after Dewey & LeBoeuf went bankrupt the productive partners quickly found other slots.

On the other hand during the Asian Boom of the 1990s salaries for entry-level Thai programmers approached those that Microsoft was paying in the US for those with 10 years of experience. This was a good bubble indicator since the Asian boom began with a surge in FDI seeking educated workers at lower wages. Once this excess labor pool evaporated and wages rose FDI fell and imports rose, triggering the bust and a collapse in foreign exchange rates that returned market wages to a sustainable global level. Indeed after the baht collapsed in value Toyota began exporting cars to Japan from their plant in Thailand. This change in exchange values along with the dramatic drop in real estate prices helped set the conditions for an economic recovery without the prior mania.

Something similar seems to be happening in higher education with respect to tuition and students’ willingness to take on debt. That is states and students are responding to economic realities but the very top colleges have no shortage of applicants just as the very top law firms continue to hire the very top law students. Further those students continue to sometimes pay a higher and higher level of tuition to those institutions.

I note “sometimes” because almost every college and university is involved in price discrimination and the elite ones even more so. Thus while the sticker price at an Ivy League School is currently around $50,000 a year many students pay substantially less than that based on need. Other private and state universities offer scholarships based on merit or athletic ability as well. In essence these schools are taxing those who can afford to pay in order to subsidize those that are less affluent. Under these circumstances it is not clear from what level a price collapse would come and whether even at these price levels applications to elite schools are actually rising not falling.

In addition just as with the CEOs where is the tradable asset? As yet we have not entered the realm of science fiction where one can download one’s educational experience and learning directly from one brain to another. Whatever education is acquired belongs uniquely to that individual and in turn by entering the job market that individual can rent that package of talent, experience and education to an employer making an economic and social contribution while gaining experience.

Of course due to the Great Recession many graduates are having difficulty finding jobs. Further given high unemployment and declining property values state and local governments are cutting back on support to public higher education shifting the cost of higher education from the general public to the actual consumers. At the same time many families feel financially stretched and thus they and their students will look for lower cost options putting pressure on financially weaker colleges and universities. These economic and fiscal forces are obvious and are creating big headaches for administrations.

Longer term this could also lead to a less well educated less productive population and to increased defaults on student loans. Therefore there is no denying that a crisis may be developing where public colleges and universities along with less well-endowed private institutions may have to make painful choices with respect to degree requirements, teaching loads and their current emphasis on research. Yet this crisis is not a bubble since there is neither an obvious tradable asset nor a clear market price for that asset which has risen relative to the CPI and is poised for collapse.

Rather if there is a bubble in higher education it only seems to be possible in the stock price of for-profit institutions such as the University of Phoenix (Apollo Group: APOL) or National American University (National American University Holdings Inc.: NAUH). But this bubble and bust may have already occurred since APOL as of August 2012 was selling around $28 a share down from a high of $90 in September 2009 and NAUH was around $4.25 down from $12.50. Thus both firms have seen their share price collapse between sixty and seventy percent from their highs.

**Not All Financial Crises Are Bubbles – Panic 1907 and Euro Crisis 2012**

While many financial crises such as the Great Depression and the recent Great Recession involve financial bubbles not all bubbles result in a financial crisis. The dotcom bubble only hurt investors in those stocks since margin requirements limited lender involvement. No “too-big-to-fail” bailouts were needed. A black letter rule put in place in response to the 1929 crash did its job. The Summer of 2012 drop in the share prices of social media companies has caused little or no economic fallout other than for those that invested or are working for them. Similarly not all financial crises involve bubbles.

Historically one of the most famous and important of US financial crises is the 1907 Panic where J. P. Morgan is credited with saving the US financial system and where Congressional hearings ultimately led to the formation of the Federal Reserve System. In their book The Panic Of 1907 (Bruner and Carr, 2007) Robert Bruner and Sean Carr describe how the 1906 San Francisco earthquake led to very large nationwide capital demands and a national liquidity squeeze that there was no central bank to offset. This situation slowly depressed equity prices particularly mining shares, leading to financial problems for several related banks that then set off a series of bank runs.

What occurred was that a group of Wall Street manipulators used a pyramiding scheme to acquire several banks, trust companies and insurance firms. Having acquired a controlling interest in one financial institution the “pool” would use that control to borrow money to buy a controlling interest in other financial institutions, securing loans with shares of the company being acquired. The investor pool’s initial capital though came from success in mining and it used shares in United Copper to secure the loans to start acquiring financial firms. Then

“ as equity prices fell broadly, the brothers became concerned about their holdings in United Copper, whose stock had been used to secure their positions in numerous banking concerns. In an attempt to support the price of their United Copper Company shares, the Heinzes began purchasing large quantities of the company’s stock and placing them on margin with as many as 20 brokerage houses on Wall Street. A dangerous game was afoot.”

After an attempted corner in United Copper stock failed the whole pyramid began unraveling with brokerage houses and in turn the banks from which they had received margin loans affected. It began with the Mercantile National Bank of which Augustus Heinze was president but spread to several related banks and brokerages the most important being the Knickerbocker Trust Company.

“Should the Knickerbocker fall, its failure would signal to the public that something more endemic was threatening the financial system. By day’s end, widespread fear and uncertainty would spread like brush fire.”

Indeed what followed was a series of bank runs as rumors and reality merged since there was no deposit insurance, an idea that only emerged later during the Great Depression. Depositors thus rushed to withdraw money from any bank or trust company that seemed weak. This of course only made the situation worse. Further as New York was the country’s financial capital whatever affected New York impacted the country and London too.

“The crash and panic of 1907 reverberated in markets, governments, and the lives of individuals throughout the United States and around the world. Commodity prices fell 21 percent, eliminating virtually the entire increase from 1904 to 1907. Industrial production dropped more than in any other U.S. panic up to 1907. The dollar volume of bankruptcies declared in November spiked up by 47 percent over a year earlier … Gross earnings of railroads fell by 6 percent in December, production fell 11 percent from May 1907 to June 1908, wholesale prices fell 5 percent and imports shrank 26 percent. Unemployment rose from 2.8 percent to 8 percent.”

The situation was only stabilized due to the efforts of J. P. Morgan who used his personal power and influence to get the stronger banks to work together to become in effect lenders of last resort, a function now done by a central bank. Nevertheless the establishment of a central bank while addressing the liquidity deficiencies of the US financial system clearly did not eliminate the possibility of financial crises, including those unrelated to a bubble but rather to natural catastrophes or fiscal mismanagement.

The Latin American debt crisis of the 1980s is an example of the latter as is the current Euro crisis. It is true that both Ireland and Spain had housing and construction bubbles similar to the U.S. that are exacerbating the crisis but its origins and underlying problems lie in Greece and the Eurozone’s economic and political system not those housing and construction bubbles.

The Euro is from an historical perspective a unique modern currency experiment in that it is a currency not tied to a single country such as the dollar, yen or pound. Thus its exchange rate is not subject to any single country’s monetary and fiscal policy. Yet exchange rates determine the international price of a country’s goods, services and assets, which means any currency regime will have winners and losers based on productivity.

If a particular country within a currency zone or region within a country with its own currency has a high level of productivity the exchange rate from its perspective will look undervalued compared to countries or sectors with lower productivity. However, all sectors within the common population are importing goods and services based on the common exchange rate. The less productive sectors will therefore buy from the more productive sectors and from abroad. Given scale, scope and experience effects this will benefit the more productive sectors making them even more competitive while keeping the currency weaker than if less productive sectors did not exist. Over time more and more resources will flow to the more productive sectors, which benefits the economy if it is a single country but may not if it is currency zone composed of several countries.

In effect there is a symbiotic relationship between the less productive and more productive sectors or regions that would end if the former disappeared since then the less productive regions would no longer be importing and the exchange rate would appreciate reducing the more productive sectors’ competitive edge. Political disagreements between the sectors would increase too.

This is why the UK Prime Minister David Cameron was correct when he stated that a successful currency regime required that the winners compensate the losers from some of their benefits through fiscal policy. New York for example complains it contributes more to the Federal Budget than it gets back. However this view fails to account for the fact Wall Street and thus New York benefits from the less productive states or regions being able to keep consuming due to those transfer payments, thus weakening the dollar relative to other currencies and making Wall Street more competitive.

A similar economic dynamic has being unfolding with respect to the Euro but without the political and fiscal offset. Within the Eurozone there are high productivity countries such as Germany, Netherlands and Finland. There are also lower productivity countries such as Greece, Spain and Portugal. For several years the lower productivity countries consumed more than they sold but not out of transfer payments. Rather they borrowed. Indeed it seems in the case of Greece the government borrowed more than they were supposed to under Eurozone guidelines but disguised this fact through a series of derivative transactions arranged by Goldman Sachs. When this became known in 2010 it triggered the Euro crisis and a weakening of the Euro because investors fled the weaker countries’ bonds. The main beneficiaries of this development were the stronger countries, especially Germany, which saw its exports soar and its unemployment drop even as unemployment in Spain jumped above 20 percent.

Given the free movement of labor within the Eurozone the logical result is for younger educated workers from countries such as Spain or Greece, especially those with engineering or technical skills, to migrate. Indeed demand for German language training is apparently soaring. Yet how long will those countries be willing to see their economic and intellectual futures leave and their economies negatively impacted while another country seems to be prospering at their expense. It is also short-sighted on the part of Germany and Finland to resist negotiating some fiscal compensation arrangement to keep these countries from leaving the Euro since that event would lead to the Euro’s immediate appreciation and a reduction in their competitiveness and economic growth.

The idea the European Central Bank will buy the weaker countries’ government bonds while helpful in the short-run is not a long term fix since it does not improve these countries economic situation in terms of productivity and employment. This requires FDI, job training and infrastructure investment. Providing capital from the European Fund directly to these countries’ banking sectors is a move in this direction since it reduces the growth in their government debt and enables their banking sectors to provide loans to business. However more is needed if those businesses are going to compete effectively under a strong Euro currency regime. Further by pulling up the bottom of the European economy the strong countries will be increasing the markets for their products. Henry Ford figured this out 100 years ago. When he raised wages to $5 a day his competitors asserted he would immediately go bankrupt. Instead he prospered and it was his competitors he drove out of business with increased productivity and market share. The most productive workers flocked to his factories and also became some of his best customers.[[3]](#footnote-3)

**Conclusion – Bubbles Are A Distinct Market Phenomena Of Misperceived Risk**

 If everything is a bubble then neither bubbles nor other financial problems will be properly identified, regulated or managed. As explained above bubbles involve the rapid rise in the real price of a tradable asset. If there is no tradable asset there is no bubble and the crisis or problem is due to something other than a bubble such as in the case of the Euro large government deficits for certain countries combined with large differentials in productivity within a single currency zone.

 While having a lender of last resort can be an effective counter to the aftermath of a collapsed bubble it will not address a financial crisis requiring the fiscal transfer of resources from a currency zone’s winners to its losers. In addition fiscal or monetary restraint or stimulus may not be the best way to manage a bubble. Apparently one reason the US has margin requirements is that during the stock market boom of 1920s the Fed raised interest rates to try to control the boom. But due to the perceived high returns in stocks this policy actually increased the funds flowing into speculation and hurt the underlying economy making the economic consequences of the collapse vastly worse.

 In sum having a proper understanding of what is and is not a bubble as well as the particular type of bubble is critical to developing related investment and government policies. Therefore proper labeling as with food is important to an economy’s health.

1. See William V. Rapp, “Foreign Firms in Japan’s Securities Industry in the 1980s and Post Bubble Economy,” in Post Bubble Japanese Business, Raj Aggarwal, ed., Kluwer Academic Publishers, Chapter 7, 1999

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 [↑](#footnote-ref-1)
2. In his book Finance and the Good Society, Shiller notes the Congressional Budget Office calculated that the real after tax income for the top 1% of US income earners grew 275% between 1979 and 2007 while for the bottom 20% of the population it only increased 18%. [↑](#footnote-ref-2)
3. Some articles related to the these points about the Euro crisis are: N. Kulish and P. Geitner, “Euro Zone Crisis Boils as Leaders Fail to Signal New Steps, “ NY Times, May 23, 2012; R. Atkins, “Migrants learn language of German boom,” Financial Times, January 11, 2012; B. Marsh, “Its All Connected: An Overview of the Euro Crisis,” NY Times, October 22, 2011; P. Krugman, “European Crisis Realities,” NY Times, February 5, 2012; J. Ewing, “Euro Zone Crisis: A Primer,” NY Times, May 22, 2012. [↑](#footnote-ref-3)