Lessons of the Bubbles

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There is evidence indicating that there was an attempt to control the supply of a significant commodity, to some degree, this stimulated uncertainty and inflationary expectations more generally. As the market price declined, funding of the speculative institutions that these conditions would continue.

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There is evidence indicating that there was an attempt to control the supply of a significant commodity, to some degree, this stimulated uncertainty and inflationary expectations more generally. As the market price declined, funding of the speculative institutions that these conditions would continue.
Recent months have witnessed a striking madness in many of the world's financial markets. Following the crises in Iran and Afghanistan, investors appeared to be moving out of commodity assets and into precious metals. The prices of silver and gold soared. Gold had been selling for less than $200 per ounce in the beginning of 1979, yet its price climbed to over $800 per ounce one year later. On January 21, 1980, gold peaked at a closing price in London of $850 per ounce; two mornings later, it "crashed" to $650 per ounce (see chart 1). The downward trend continued until gold reached its 1980 low point of $480 per ounce on March 17; the price of gold has since hovered close to $520.

Silver prices exhibited a similar pattern, following gold prices upward and then quickly downward. Silver sold for $2 per ounce in the early 1970s. By mid-January 1980, silver was selling briefly at more than $400 per ounce, but plummeted to $14 per ounce by late March, where it has remained since. In perhaps the largest financial losses ever suffered by any single family, the Hunt brothers of Texas and their Arab partners lost millions of dollars when the silver market crashed. The Hunts had been buying large amounts of the existing supply of the metal in order to support the rapidly climbing price of gold. In a few cases, bubbles have developed in such markets as tulip bulbs, stocks, bonds, foreign exchange, land, real estate, and commodities. Stock markets have experienced many speculative cycles. Perhaps the most unforgettable was the New York stock market crash of 1929, which symbolized the onset of the Great Depression. Between January 1926 and September 1929, prices on the New York Stock Exchange more than doubled, and the boom seemed impressive range of swindles and bribery in markets as tulip bulbs, stocks, bonds, foreign exchange, land, real estate, and commodities. Stock markets have experienced many speculative cycles. Perhaps the most unforgettable was the New York stock market crash of 1929, which symbolized the onset of the Great Depression. Between January 1926 and September 1929, prices on the New York Stock Exchange more than doubled, and the boom seemed unsustainable (see table 1). As President Calvin Coolidge left office in March 1929, he claimed that the "over boiling" fever prevails when the prices buy low and sell high. The stock market crash of 1929, stock prices fell by 80 percent on average.

Two of the most famous speculative crises were the South Sea and the Mississippi Bubbles of the early eighteenth century. In 1716, John Law, a fugitive from Scotland, set up the Banque Generale in Paris; this bank became the equivalent of a central bank for France. Law used his position to expand the money supply in France in order to support speculation in shares of the Compagnie d'Ocicident, a trading company that he controlled. This "Mississippi Company" had a monopoly on trade with the French territories in the New World. In early 1719, a speculative boom began in Mississippi shares. Between July 1719 and January 1720, share prices rose an average of 10 points per day. Over 30,000 investors flocked to Paris to speculate, and the word millionaire was first coined. Eventually, the French government forced Law to stop printing money because of the inflation that it caused; the price of Mississippi shares crashed. At almost the same time in London, a bubble began for shares in the South Sea Company, a firm that was to expand trade with the Spanish colonies in South America. The company was controlled by John Blunt and his associates, who performed an impressive range of swindles and bribery in order to support the rapidly climbing price of shares. Diverse foreign governments, fearing that they could lose control of trade with the New World in London in 1720, particularly after the crash of the Mississippi stock. South Sea shares also were marketed throughout Europe. Fortunes were made but as quickly lost when the price crashed in the autumn of 1720.

Speculative Cycles of the Past Speculative bubbles have been observed in such markets as tulip bulbs, stocks, bonds, foreign exchange, land, real estate, and commodities. Stock markets have experienced many speculative cycles. Perhaps the most unforgettable was the New York stock market crash of 1929, which symbolized the onset of the Great Depression. Between January 1926 and September 1929, prices on the New York Stock Exchange more than doubled, and the boom seemed unsustainable (see table 1). As President Calvin Coolidge left office in March 1929, he claimed that the "over boiling" fever prevails when the prices buy low and sell high. The stock market crash of 1929, stock prices fell by 80 percent on average.

Table 1: Profiles of Several Speculative Bubbles

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<tr>
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<tbody>
<tr>
<td>Initial price</td>
<td>$200/ounce</td>
<td>$6/ounce</td>
<td>$100/stock</td>
<td>$10/share ($1719)</td>
<td>$300/share ($1719)</td>
</tr>
<tr>
<td>bubble began</td>
<td>(early 1979)</td>
<td>(early 1979)</td>
<td>(July 1926)</td>
<td>(July 1720)</td>
<td>(early 1719)</td>
</tr>
<tr>
<td>Peak price</td>
<td>$450/ounce</td>
<td>$48.70/ounce</td>
<td>$216/share ($1720)</td>
<td>$20,000/share (early 1720)</td>
<td>($1720)</td>
</tr>
<tr>
<td>Price after crash</td>
<td>$518/ounce</td>
<td>$14.05/ounce</td>
<td>$34/share ($1720)</td>
<td>$60/share ($1720)</td>
<td>Worthless (December 1720)</td>
</tr>
</tbody>
</table>

In a few cases, bubbles have developed in response to the efforts of some speculators' attempts to "corner" a market, by purchasing large amounts of the existing supply of the product.
Recent months have witnessed a striking madness in many of the world's financial markets. Following the crises in Iran and Afghanistan, investors appear to be moving out of dollar assets and into precious metals. The prices of silver and gold soared. Gold had been selling for less than $200 per ounce in the beginning of 1979, yet its price climbed to over $800 per ounce one year later. On January 21, 1980, gold peaked at a closing price in London of $850 per ounce; two mornings later, it "crashed" to $650 per ounce (see chart 1). The downward trend continued until gold reached its 1980 low point of $480 per ounce on March 17; the price of gold has since hovered close to $520.

Silver prices exhibited a similar pattern, following gold prices upward and then quickly downward. Silver sold for $2 per ounce in the early 1970s. By mid-January 1980, silver was selling briefly at more than $50 per ounce, but plummeted to $14 per ounce by late March, where it has remained. In perhaps the largest financial losses ever suffered by any single family, the Hunt brothers of Texas and their Arab partners claimed to have established a link between the silver market and the supply of oil. As the price of oil climbed, the price of silver also rose; this caused; the price of silver to crash. The Hunts had been buying silver out of dollar assets and into precious metals. This fact should be a source of considerable irritation to proponents of the "rationa1 expectations" school of economics. Even if the effects of speculation are stabilizing, one must consider the possibility that wildly fluctuating prices sometimes occur because of destabilizing speculation.

Speculative booms and busts have occurred for hundreds of years. Indeed, in the nineteenth century many observers claimed to have established a link between such market madness and sunspots. The typical pattern of a speculative bubble is as follows:

1. Speculation centers on one commodity or set of commodities; 
2. As the price of the commodity rises, people begin to expect that the price will continue to rise; 
3. This expectation leads to more buying and higher prices, which in turn reinforces people's expectations; 
4. The price continues to soar, until suddenly expectations reverse themselves; 
5. Then the price crashes, as people sell in panic, trying to get rid of the specific commodity before the price falls even further.

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At almost the same time in London, a bubble began for shares in the Banque Generale d'Occident, a trading company that he controlled. This "Mississippi Company" had a monopoly on trade with the French territories in the New World. In 1719, a speculative boom began in Mississippi shares. Between July 1719 and January 1720, share prices rose an average of 10 percent per day. Over 30,000 speculators flocked to Paris to speculate, and the word millionaire was first coined. Eventually, the French government forced Law to stop printing money because of the inflation that it caused; the price of Mississippi shares crashed.

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I can calculate the motions of the heavenly bodies, but not the madness of people.

SIR ISAAC NEWTON

who lost £13,000 in the South Sea Bubble

remains an important don in the side of many economic doctrines. Most economists spend a great deal of their time admiring the rational and optimally efficient characteristics that markets generally exhibit. Speculative swings are really abnormal exceptions to this rule, and are quite rare when compared with the more common pattern of efficient market behavior. However, markets in the midst of mania or panic cannot be said to be operating efficiently or "rationally." This fact should be a source of considerable irritation to proponents of the "rational expectations" school of economics. Even if the effects of speculation are stabilizing, one must consider the possibility that wildly fluctuating prices sometimes occur because of destabilizing speculation.

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by Steven E. Plaut

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The prices of silver and gold soared. Gold latched on higher silver prices found themselves considerably poorer. More Silver and Gold: Some Sober Thoughts on Speculative Bubbles

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The South Sea Bubble

In 1719, a speculative boom began in Mississippi shares. Between July 1719 and January 1720, share prices rose an average of 100 points per day. Over 30,000 people flocked to Paris to speculate, and the word millionaire was first coined. Eventually, the French government forced Law to stop printing money because of the inflation that it caused; the price of Mississippi shares crashed.

As at almost the same time in London, a bubble began for shares in the Mississippi Company, a firm that was to expand trade with the Spanish colonies in South America. The company was controlled by John Boulton and his associates, who performed an impressive range of свиделей и бирюк в центре правительства союзной страны в поддержку спекулятивного взлета посредникам. The bubble crashed after the company's shares were cheap at current prices. Between September 1720 and December 1932, stock prices fell by 80 percent on average.

Two of the most famous speculative crises were the South Sea and the Mississippi Bubbles of the early eighteenth century. In 1719, Mississippi securities were worth less than £35 per share; when the stock market crashed, the price fell to £250 per share. The bubble crashed in the autumn of 1720.

2. For a history of these speculative bubbles, see Charles P. Kindleberger, Manias, Panics, and Crashes (Basic Books, Inc., 1978).
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Lessons of the Bubbles

Speculative bubbles tend to be fueled by expanding inflationary expectations, rapid speculation, and a willingness to pay for investment.\(^6\) They also seem to spread easily from one commodity to another. Speculative bubbles in silver and gold likewise spread to other commodities. The Wall Street crash in 1929 spread to European financial markets.

Speculative fever is often the temptation that triggers unscrupulous dealings. Swindles then arise in many imaginative forms. One of the most popular swindles—originally used by the South Sea Company directors—involved the “chain letter” scheme. In this swindle, dividends are paid to old shareholders with revenues from the sales of new stock. As the market for new stock breaks, the people near the end of the chain suffer. Even today, the “chain letter” continues to be one of the favorite methods of swindlers.

Bubble Bursting

Can speculative bubbles be prevented? Although there may be no way to ensure that bubbles would not occur, perhaps some steps could be taken to make their occurrence less likely or at least to mitigate their consequences. The U.S. Congress has promulgated a number of laws to prevent speculative bubbles. The Securities Exchange Act of 1934 delegated the authority to regulate securities credit to the Board of Governors of the Federal Reserve System. The Board sets a minimum margin requirement that specifies the minimum down payment required for a securities transaction. The Board’s Regulation T, U, G, and X specify the terms and conditions that various lending institutions and borrowers must follow when securities credit is extended. The Board may raise the margin requirement to restrain the extension of money and credit, and economic authorities thus avoiding the encouragement of even more speculation.

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Speculative bubbles tend to be fueled by expanding inflationary economies, rapid price rises, and credit. Where prices rise, there is a greater use of credit for purchasing or carrying securities. In addition, the Securities and Exchange Commission and the Commodity Futures Trading Commission oversee the securities and commodities markets, respectively. All of these regulations represent interventions in the normal day-to-day operations of markets.

These markets ordinarily perform a number of essential functions, including allowing numerous traders to hedge risks. While the costs of maintaining these regulations during periods of “normal market behavior” have not been formally estimated, they are doubtless considerable, and reduce the efficiency of these markets. Yet, there is a question to be asked: to what extent can the regulations be maintained to safeguard against the extreme swings to which these markets are prone. In spite of the regulations, these swings occasionally occur, and there are serious questions as to the effectiveness of the regulations in preventing speculative bubbles.

Regulating speculation is considered as more an art than a science. Consider the difficulties in any such policy. We know that speculation can lead to large losses. Paul A. Volcker, the Federal Reserve Board chairman, said, “The authorities never intervened, some bubbles perhaps would end harmlessly, except for the losses to those speculators caught in the crash. But, repercussions of the collapse of speculative bubbles could be severe, reaching—extending beyond the effects on the participants most directly involved. In such cases, failure of the authorities to

The views stated herein are those of the author and not necessarily those of the Federal Reserve Bank of Cleveland or the Board of Governors of the Federal Reserve System.

NOTE: No Economic Commentary was published on April 21, 1980.