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IN BUBBLE TERRITORY

What is the next bubble?

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BUBBLE VS BUSINESS CYCLE

Over the last few decades business cycles have prompted plenty of discussions among economists – some fruitful, some not as much. However, after the end of the Cold War the opening of new markets and possibilities, the even stronger globalisation processes and allegedly smarter government policies resulted in a long period of minimal inflation and very low interest rates in the US throughout the 1990s. This led some economists (like prof. Steven Weber/ 1997) to declare the end of business cycles as we know them and a future of prosperity. But then came a contraction – one that was as strong as the seemingly unending preceding expansion should have indicated. Business cycle theory was resurrected and old fiscal and monetary stimuli were carved out once again in a desperate countercyclical effort.

The first word to cast fears among politicians, media and business people alike was “depression”. Now that it has become clear the crisis is not turning into a depression and that economies will eventually head for a recovery, however slow that might be, the experience from the painful bust of the mortgage market bubble returns to mind. “Bubble” has become the new word of the day. Theories about the causes for such excessive price fluctuations in some markets and about ways to identify them early have failed to provide comprehensive instruments to forecast bubbles – where they will emerge and what spillover effects they might bring about for the national and global economy.

While more layman explanations about the tendency of markets to form bubbles such as the Greater fool theory or the Bounded rationality assumption have been proven unfounded by experimental means (Levine, Zajac, 2001), conclusions about the institutional nature of price bubbles exhibit the social foundations of bubbles, or, as the authors of the research put it: “individuals observe each other and base their decisions, at least partly, on imitation of others rather than on their own cognition”. Yet, this institutionalization theory partly reveals the mechanism of bubble forming but does not touch upon questions such as “Why do bubbles occur on a specific market?” or “When do they occur (under what circumstances)?”. The first question is undoubtedly the hardest to answer, especially *ex ante*. Among popular explanations are factors such as government regulations, which create looser conditions and greater investor benefits in some sectors, speculators, who attract large-volume trading with certain assets, technological innovation, geopolitical changes etc.

The second question has a more solid theoretical backing – that of the Austrian business cycle theory. The latter goes deep into the matter of business cycles and concludes that throughout history cycles occur in response to monetary intervention, causing some form of loose monetary conditions in terms of an increase of banknotes, of bank deposits and bank credits, an increase in the circulation of checks, bills and other means of payment as well as an increase of the velocity of circulation of one or all of these means of payments. The first

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occurrences of government-induced price bubbles date back to the foundation of the first central banks in Europe – the Bank of Amsterdam, the Royal Bank in France and the Bank of England (D. French, 1992).

The link between a bubble and the business cycle goes both ways – the expansion phase (usually boosted by a monetary or a credit expansion) inflates one or multiple bubbles, while the bubbles themselves fuel expansion and prolong it. Growth generally means that the economic agents earn more money, which goes into consumption or savings in a relation determined by the time preferences of individuals. Thus we have proportionately larger consumption and savings, alas only in theory. In practice growth itself can change the time preferences of individuals as it changes their expectations for the future. Through low interest rates monetary policy is also capable of meddling with time preferences – it gives way to long-term investments, which bring higher yields and given the positive expectations of individuals create a false impression of minor risks. All this new “long-term money” is searching for capital goods to invest in (as we expect growth, investors know that growth means more demand for capital goods i.e. greater gains from investment in such). This situation can be described as the foaming stage of a forthcoming bubble – we just need to wait and see where all that money will flow to. When it finds its place, the so-called institutionalization of markets’ behaviour steps in and a bubble starts to inflate. Even if central bankers notice the bubble, they are not inclined to tighten monetary policy to constrain the inflation of the bubble, because that same inflation is creating a growth even greater than the expected one. So politically it is a suicide to prevent that bubble from growing further because everyone likes the growth – not only the ones directly gaining from the bubble, but also industries indirectly related to it. Plus, the already loose credit conditions make everything look like its growing, so the bubble doesn’t really seem as bubbly at the time, as it seems ex post.

WHAT MIGHT JUST FIT THE BILL

Taking the mentioned aspects of bubble formation into account gives a vague idea where we could look for the next bubble in the making. If we search for the circumstances, the Austrian School points out as foamy, we first stumble upon the record-low central banks’ interest rates in the USA and Europe. The contraction that the global financial crisis brought about was countered by central banks by means of expansionary policy. For example, the effective federal funds rate – the interest rate of overnight interbank lending at the Federal Reserve – stood at 0.11 per cent on February 22, 2010 as compared to 5.25 per cent on February 20, 2007. The fixed interest rate of the European Central Bank was also at a low of 1 per cent and neither of them has declared an engagement to let go of the expansionary policy in the near future. Central bankers have stopped fearing inflation as much as they did before, at least inflation measured by consumer prices. Hopefully sooner rather than later they

will realize that commodities, other capital goods and financial assets now pose a much greater threat.

So clearly the weather is fine for a bubble... or a few of those. As the financial storm is blowing over, investors are crawling out of the safe havens they previously saw in sovereign debt and precious metals and seek for promising investments that could bring higher yields. Although many analysts proposed that the next bubble would come exactly from assets such as treasury bills or gold, those minor bubbles have lost momentum and started to stabilize without having reached a dangerous magnitude. In the long term emerging markets now present the most attractive destination: they promise long-term growth with high returns as well as plenty of room for speculation. There is also some feeling of a new era dawning: as economic growth now comes primarily from the eastern hemisphere, economic power is also shifting, most notably from the US to China. Much like the sense of never ending prosperity that financial innovation and cheap credit created in the US at the time when the mortgage market was booming, market participants are now confident that if emerging markets could keep on growing throughout the worst recession since the Great Depression, they can never stop.

Within the last year the MSCI index for the BRIC stock markets has surged by 93 per cent. At the same time the VIX index, which measures fear among investors, has fallen by 87 per cent. This development outlines a clear trend but it is yet disputable whether it marks an overpricing beyond fundamentals or it is just a correction of the preceding slump below the markets' fundamentals. In my opinion, these markets have not yet entered bubble territory, yet they are on its threshold. The longer the West continues to pump money into the markets via close-to-zero interest rates and quantitative easing programmes, the more probable a bubble will become.

To predict where a bubble might emerge and to say at what stage it would burst and how big the spillover effects for other sectors and economies would be are, however, two very different things. We have already seen bubbles in many places at different points in time. The most recent ones – the dot-com bubble and the bubble, followed by the Asian financial crisis – had a limited effect on the global economy. The former did substantial damage but stayed somewhat limited to the IT sector and it only caused the economy to hiccup, while the latter's effects were limited to a certain region. What makes me believe that another emerging markets bubble might have a more severe impact on the global economy than the Asian crisis from the late 90s?

The damage a bubble does when it bursts depends on what links exist between the bubble asset and other assets, circulating within the economy, as well as on the velocity of that circulation. The reason the Asian bubble became a financial crisis in the region and the dot-com bubble made some massively overvalued IT companies go bankrupt instead of causing a worldwide economic slowdown was

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the fact that those bubbles were confined to the trading of the bubble asset but the latter did not become a partial substitute for money. In contrast to those cases, we could look back to the Mississippi bubble fueled by John Law or the South Sea Company bubble in England. In both cases the assets around which a bubble evolved were shares of companies, issued to cover government debt, i.e. they were a means to create money out of thin air. The result was devastating for the entire French and the English economies, as it meant a busted means of exchange for all sectors. At the time being it was yet not possible to speak of spillover effects for a whole region given the feebler economic links between the countries.

If we look at the mortgage market before 2007, we could notice a number of similarities to those early bubbles. Through securitization financial engineering was able to construct derivative products with very low risk and higher yield. How great a treat those were to banks can be understood in the light of financial regulations, mainly Basel II and its capital adequacy requirements. The capital adequacy regulation was aimed at creating risk-weighted capital bases instead of the Basel I general capital adequacy that did not stimulate banks and enterprises to aspire to higher standards of financial soundness. What that meant was that if banks wanted to invest in high-yield instruments with a lesser credit rating, they had to shore up massive own capital. Alternatively, they could keep their core capital more modest but stick to a more conservative investment policy and give up hefty premiums. In that respect derivative mortgage products gave them the ability to invest in almost risk-free assets (according to the leading rating agencies) and have enough leeway to invest more of their capital in lucrative high-yielding stuff. Thus, via the erroneously rated derivatives the banks could boost the money multiplier, i.e. they created money out of the bubble asset. As with the South Sea and the Mississippi bubbles, when the asset bubble burst, the additional money poured into the economy evaporated. Well, as we know Basel II is an international standard as are derivatives markets, which simply meant that the newly cast money evaporated not only from the economy it was created in, but from all economies where the products were traded.

Similarly the global financial crisis brought about talk of greater financial regulation. Bonus caps, a resurrection of the Glass-Steagall Act in the US, new risk management requirements have been the main subject of policy disputes in the western world. Like most regulations in the financial sector, however, these seem likely to have ambiguous effects. Considering the growth of emerging financial markets with looser regulations and their immediate proximity to the investment targets, the global financial sector is likely to let go of the traditional financial centres and shift to more flexible ones. This means that a bubble in the emerging markets will not repeat the Asian crisis scenario, as then capital inflows were generated by foreign portfolio investments, which tend to come in great numbers when the times are good and flee panicky when things go bad. In the event of a change in financial sector concentration this herd behaviour would become less distinct. Furthermore, a greater concentration of financial companies

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in emerging economies means that the latter would “enjoy” an inward multiplication of money supply rather than reap the benefits of money out of thin air, created elsewhere.

It is obvious that the drafted bubble scenario is unlikely to come true in the short term – all the circumstances required for such a major bubble in the emerging markets will need years and a lasting governments’ appetite for monetary expansion to manifest themselves. However, the mortgage market bubble is also estimated to have started growing around 1996-97 and it needed around ten years to make for a memorable bust.

STILL THE FOAM IS NOT AT REST

In the meantime, however, the market will most certainly make use of the extra money supply central bankers and a recovering banking system endeavour to pump into the system. In the course of a major bubble slowly inflating in the long term, the volatile monetary conditions are likely to spur a number of small-scale bubbles like for instance the oil price bubble that popped in 2008. In the near future a new market hype might come from green tech companies. As long as the climate protection propaganda keeps running and politicians try to make unclear commitments to cut carbon emissions and generate electricity from renewable sources, the markets will put part of their resources into the green hype. In the long term, however, the economic viability and scientific foundations of many of the new technologies is likely to turn out to be not as good as investors now bet. At some point in the course of the natural selection process the market will get rid of the unprofitable projects and the bubble will deflate.

If we look at the bigger picture over the last few decades we have had an excessive amount of small bubbles in various markets. Bubbles are becoming a commonplace phenomenon that yet no one can give a complete and reasonable explanation to. They seem to pop up every now and then, whenever investors refuse to see that no growth is unending. In some kind of wishful thinking they stop trusting their rational pricing models and forget former experience. Then ex post their behaviour is interpreted via a set of factors that all seem very important, but which all have failed to take into consideration during the boom. Perhaps Taleb is right and people are profoundly unable to predict future developments, especially important ones. Yet, there is also something else in the markets’ tendency to exaggerate hopes and underestimate fears and uncertainties... A strange and new common belief among all participants that even if they incur losses from this bubble, there will always come a bigger one, from which they will gain more. A belief carved in popular expectations by already centuries of an almost constantly growing money supply due to central bank expansionary policy combined with fractional reserve banking.

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