BUBBLES OF TROUBLE

INVESTIGATING A PHENOMENON THAT HAS ENRICHED SOME, RUINED MANY AND SHAPED HISTORY

ECONOMIC BUBBLES — OVER THE PAST FOUR CENTURIES THEY'VE BEEN INFLATED BY VISIONS OF WEALTH FROM TULIPS (YES, TULIPS), INTERNATIONAL TRADE, RAILROADS, BIOTECHNOLOGY AND THE INTERNET. THEIR BURSTING HAS BEEN DISASTROUS FOR INDIVIDUALS AND ENTIRE NATIONS. THE U.S. AND OTHER COUNTRIES ARE STILL REELING FROM THE RECENT HOUSING BUBBLE, WHICH THREATENED THE GLOBAL ECONOMY.

LEADING IN BUBBLE RESEARCH

There's no doubt that bubbles merit the in-depth study needed for better understanding of why and how they develop, how to predict them, and how to contend with the economic mess created when they collapse. At NJIT, this is the goal of Professor William Rapp, director of the School of Management's new Leir Center for Financial Bubble Research.

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One of the few to warn of the housing bubble's dangers well before it burst, Rapp came to NJIT in 2000 as Leir Professor of International Trade and Business. Today, a comprehensive research program that includes reexamining the history of bubbles to glean fresh insights with contemporary relevance is being organized by Rapp and Assistant Professor Michael Ehrlich, associate center director. The value of this unique effort is underscored by the increasing frequency of bubbles over the past few decades, which Rapp and Ehrlich say may represent the return to a historic norm. While we will have to contend with the many negative aspects of this trend, the two researchers also offer the intriguing idea that there may be "good" bubbles.

STARTING WITH REAL VALUE

As Rapp explains, a bubble begins with interest in an asset that has real value, one which does warrant significant investment. It's even true of the tulip mania that swept Holland in the 17th century, widely considered to be the first bubble to roil a recognizably modern free-market economy.

The popularity of tulips, an exotic import from the Ottoman Empire, was such that some bulbs sold for ten times the annual income of a skilled craftsman. This reflects another defining characteristic of bubbles, that the price of the sought-after asset rises much more rapidly than virtually all other prevailing prices.

The 18th century saw two especially notable and pernicious bubbles. The South Sea Bubble was inflated by the sale of shares in a British company promoting trade with South America, while those ensnared by the Mississippi Bubble sought to cash in on the prosperity of the French colony of Louisiana.

The frenzied speculation of Britain's 18th-century South Sea Bubble inflated the stock of a company promoting trade with South America.

But there comes a time when expecting that the price of an asset will continue to increase is irrational. Nonetheless, thinking otherwise, speculators keep inflating the bubble, typically with borrowed money. When this becomes unsustainable, the price plummets, speculators default on their loans, and lenders involved are dealt a losing hand as well. The economic aftershocks from the collapse of last decade's housing bubble ruined the lives of millions of individuals and precipitated the demise of banks and investment firms once thought to be financial bedrock.

BACK TO THE NORM

Looking back at the evolution of capitalist economies, Rapp and Ehrlich see an increasing incidence of bubbles, concluding that they were occurring at roughly five-year intervals in the U.S. at the start of the Great Depression in 1929. They are also among those who feel that the Depression and World War II dampened the occurrence of bubbles in this country, with government economic intervention and social consensus bolstering relative stability.

By 1980, the social compact forged by the Depression and war was dissolving, and bubbles once again became a recurring feature of the financial landscape. "We may have returned to the 'norm' of seeing bubbles develop every five years or so," Rapp says.

BAD BUBBLES, GOOD BUBBLES

But are all bubbles harmful to the same degree? Not necessarily, says Rapp, of a concept he and Ehrlich also say is controversial. When some bubbles collapse, even though they create economic distress of varying duration, they

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leave behind assets with significant value – assets that become more valuable over time.

Long the textbook case of irrational bubble psychology, tulip mania may actually have had a bright side according to Rapp. It may have seeded the gradual rise of the Netherlands to its current dominance in the global horticulture market.

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Overly optimistic investment in U.S. railroads in the 19th century left the nation with vital transportation infrastructure. It can be argued that the biotechnology bubble of the early 1990s encouraged people to study for careers in biology, medicine and related fields, creating "human capital" invaluable in the 21st century. And would the Internet have become so intertwined with our lives so quickly without the inflation of that bubble at the turn of the millennium?

On the other hand, Rapp and Ehrlich have doubts about the ultimate value of much of the foreclosed and empty housing that's the legacy of the most recent bubble to trouble the economic waters. Time will tell.

Going forward, the possibility that certain bubbles have a redeeming aspect is one of the areas that Rapp, Ehrlich and their colleagues intend to explore. They will also be researching measures, including regulatory policies, that might help to mitigate widespread economic damage from bubbles.

During the Great Depression, the Banking Act of 1933 established the Federal Deposit Insurance Corporation. It also constrained banks from making risky investments with money that depositors expected would be used for secure mortgage and business loans. Effectively eliminating this firewall between commercial and investment banking by 2000, many experts believe, played a major role in precipitating the sub-prime mortgage crisis and economic collapse that followed.

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"The challenge is to formulate new policies that guard against another such catastrophe and yet not discourage the adventurous spirit fundamental to economic progress," Rapp says. "It's good that there are people willing to invest in the 'next big thing,' to gamble on innovation. However, it's also necessary to protect the money of people who don't want to be gamblers."

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LAST ONES STANDING

Substantial support for bubble research at NJIT is coming from the Leir and Ridgefield Foundations, established by the industrialist and philanthropist Henry J. Leir and his wife, Erna. The genesis of this support was Rapp's longtime interest in bubbles, and his prescience about the collapse of the housing bubble detailed in a paper prepared for an international conference. He subsequently submitted his paper to the Foundations in the hope of a grant for additional research at NJIT, which he did receive. The response to further insightful analysis directed by Rapp was very positive, leading to funding for NJIT's bubble-research center.

The continuing commitment that the Leir and Ridgefield Foundations have made to NJIT comes at a critical time, Rapp says. As economically traumatic as the U.S. housing bubble has been, it's already fading from the headlines. In Rapp's estimation, the global news media now pays far more attention to the European debt crisis. He feels that's also true for the majority of researchers who were motivated to study bubbles in the wake of the housing fiasco.

"We may not know exactly when the next bubble will start to inflate or what will fuel the excitement of speculators, but you can be sure that bubbles will be part of our economic future," Rapp asserts. "Although we may be among the last ones standing today when it comes to the extent of our research, we intend to sustain this effort at NJIT. What's more, we invite all those interested to share the work of learning as much as possible about a phenomenon that will impact daily life for a very long time to come." ■

Author: Dean L. Maskevich is editor of NJIT Magazine.

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Visit www.leirbubblecenter.org to learn more about the Leir Center for Financial Bubble Research and how to become a corporate member.

A September 14-15 conference will focus on the need for policies to contain the negative effects of bubbles without hindering economic progress. For more information, contact Professor William Rapp at rappw@adm.njit.edu or Assistant Professor Michael Ehrlich at michael.a.ehrlich@njit.edu.