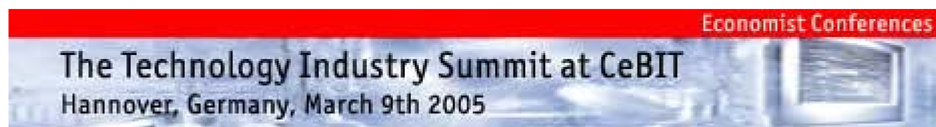

Economist.com **OPINION**

Economics focus

Of manias, panics and crashes

Jul 17th 2003
From The Economist print edition

The work of Charles Kindleberger, who died on July 7th, has never been more pertinent

"A LOT more economists than you might think can write well," says Peter Dougherty, Princeton University Press's economics editor, who is compiling an anthology to be called "The Elegant Economist". A slim volume, you might imagine, but Mr Dougherty reels off a long list of those who have put aside equations and supplied a well-turned phrase to explain the dismal science. Adam Smith wrote memorably sometimes, but he is a harder read than John Maynard Keynes or Milton Friedman, let alone John Kenneth Galbraith, so stylish a writer that he was once asked to join the English faculty at Berkeley. Mr Dougherty ranks Paul Krugman and John Kay, who each have a newspaper column, as the best today. He believes there is more talent among economics writers now than ever, perhaps fittingly as a result of fiercer competition. But, says Mr Dougherty, the "model for economists who want to reach a wider audience" was surely Charles Kindleberger, who died on July 7th, aged 92.

A self-confessed "literary economist", Mr Kindleberger, a professor at MIT and the author of more than 30 books, was a critic of the growing reliance of the economics profession on mathematics and on what he regarded as over-narrow rational models of human behaviour. Only a few years ago, his work would have been praised more for its readability than its insights. But he lived to see his best-known book become essential reading on Wall Street and be cited approvingly by younger, more mathematically inclined academics.

In "Manias, Panics and Crashes", Mr Kindleberger provided a comprehensive history of financial crises, stretching back to before the South Sea bubble. He argued, not wholly originally, that several common threads linked these different disasters over the centuries in almost all corners of the financial world. Manias, or bubbles, have typically occurred in the markets following unexpected good news, and so reflect progress of sorts. "New opportunities for profit are seized, and overdone." When this eventually dawns on investors, the financial system may experience distress and often panic.

His book first appeared in 1978, when most economists who studied finance were in thrall to efficient-markets theory, which in its purest form rules out the possibility of bubbles. In so far as it acknowledged past bubbles, the theory blamed them on immature, fraud-prone markets and argued that they were unlikely to occur in sophisticated, well-regulated, modern settings.

The recent dotcom bubble, following such other apparent inefficient-markets events as the 1987 stockmarket crash and the Asian meltdown of 1997-98, changed that, although pure efficient-markets theory was by then already under fierce attack. Mr Kindleberger's work suddenly seemed spot on. Now, studying bubbles is all the rage in academia. There are several schools of thought. "Behavioural" economists, for instance, see recent bubbles as evidence that markets are

"irrational", reflecting psychological biases such as over-optimism among investors.

Perhaps more interesting has been the reaction of those most loth to abandon rational *Homo economicus*. Only a few old believers cling to the idea that the rise in dotcom share prices genuinely reflected likely profits, and that their sudden plunge was caused by regulatory (in) activity. Most prefer to ask why informed, rational investors failed to arbitrage away the absurdly high prices caused by irrational buying, as efficient-markets theory predicts. In a 1997 paper, "The Limits of Arbitrage", Andrei Shleifer and Rob Vishny noted that the cost of shorting—selling borrowed securities in the hope of a fall in price—tends to increase, the further above true value that prices rise. This may discourage arbitrage that would bring the market back to its senses.

In a similar spirit, Matthew Richardson of New York University argues that a limited float of dotcom shares prevented short-sellers from borrowing shares to sell. When the supply of shares rose, the bubble popped. Others argue that investors who saw that the market had gone daft may quite rationally have driven prices up further, believing they could get out faster at the peak than the greater fools who would buy shares from them. Not everybody is convinced by such theories. Peter Garber, who has disputed whether some famous crazes, such as the Dutch tulipmania in the 1630s, were really bubbles at all, says there may now be a bubble in bubble theories: "Academics increasingly say there is a bubble as a substitute for thinking hard about the fundamentals of security valuation."

In the last resort

Mr Kindleberger believed that "markets work well on the whole", but occasionally "will be overwhelmed and need help" from a lender of last resort. He understood both the danger of inaction by such a lender and the "moral hazard" that its mere existence can create, by encouraging investors to be reckless in the belief that they will be bailed out if all goes wrong. Thus, he argued, a "lender of last resort should exist, but its presence should be doubted." It should always come to the rescue, but "always leave it uncertain whether the rescue will arrive in time or at all, so as to instil caution." Pulling this off is, he noted, a "neat trick".

Economists are split over the recent performance of America's lender of last resort, the Federal Reserve. Some argue that its policy of easy credit inflated the bubble, although nobody can be certain what effect tighter money would have had once the bubble began to expand. Some economists believe that the Fed's interest-rate cuts since the bubble burst have been a triumph, preventing a severe recession. Others think that the Fed has merely postponed the day of reckoning. We will never know what conclusion Mr Kindleberger would have reached. What is certain is that he would have expressed it with clarity and wit.

The fourth edition of "Manias, Panics and Crashes", (Wiley), by Charles Kindleberger, was published in 2000. (Amazon.co.uk)

"The Limits of Arbitrage", by Andrei Shleifer and Rob Vishny, appears in the *Journal of Finance*, March 1997.

The best introduction to the behavioural finance approach to bubbles remains "Irrational Exuberance", (Princeton University Press), by Robert Shiller, first published at the peak of the bubble in March 2000. (Amazon.co.uk)

Peter Dougherty displays his own flair for writing about economics in "Who's Afraid of Adam Smith?", (Wiley), published in 2002. (Amazon.co.uk)

"Famous First Bubbles: The Fundamentals of Early Manias", (MIT Press), by Peter Garber, includes an analysis of tulipmania.

Interesting recent papers on bubbles include:

"DotCom Mania: The Rise and Fall of Internet Stock Prices", by Matthew Richardson and Eli Ofek, NBER working paper, December 2001;

"Bubbles and Crashes", by Dilip Abreu and Markus Brunnermeier, *Econometrica*, 2003;

"Overconfidence and Speculative Bubbles", by Jose Scheinkman and Wei Xiong, *Journal of Political Economy*, 2003.

Copyright © 2005 The Economist Newspaper and The Economist Group. All rights reserved.