Lessons of the Bubbles

Speculative bubbles often cause widespread economic disruption, both when prices soar and when they crash. Kindleberger argues that, as speculation spreads, credit is pulled away from its normal uses of supporting investment and consumption of real goods. Thus, production may begin falling, even in the midst of the speculative mania. Expenditure may fall because of restrictive monetary policy aimed at choking off the mania. In 1929, prices of several commodities were already falling, even as stock prices soared. Residential and nonresidential construction had been falling since 1926 and continued to fall until the early 1930s.

On the other hand, when prices crash, speculative bubbles may begin to collapse, some of those institutions were pulled away from their normal uses of supporting investment and consumption of real goods. Thus, production may begin falling, even in the midst of the speculative mania. Expenditure may fall because of restrictive monetary policy aimed at choking off the mania. In 1929, prices of several commodities were already falling, even as stock prices soared. Residential and nonresidential construction had been falling since 1926 and continued to fall until the early 1930s.

Speculative bubbles tend to be fueled by expanding inflationary economies, rapid expansion of money and credit, and expectations that these conditions would continue. Bubbles also seem to spread easily from one country to another. The Mississippi Bubble spread to the South Sea Bubble and then to the shares of other companies. Speculation 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—is the “chain letter” method. In this swindle, dividends are paid to old shareholders with revenues from the sale of new shares. When the chain breaks; the people near the end of the chain eventually have, wittingly or not, committed an excessive amount of their own capital in support of a speculative activity in one commodity by a single group of people. As the market valuations collapsed, some of those institutions were placed in jeopardy; and their failure could in turn have triggered financial losses for others and severe financial disturbances.


Speculative bubbles and borrowers must follow when securities credit is extended. The Board may raise the margin requirement to restrict the expansion of money and credit, and economic authorities may take steps to reduce the 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 important measures in the normal day-to-day operations of markets.

These markets ordinarily perform a number of essential functions, including pricing, allowing numerous transactors 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, in some cases, it may be possible to safeguard against the extreme swings to which these markets seem 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.

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 margin requirement that specifies the minimum down payment required for a securities transaction. The Board’s Regulation U, T, 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 restrict the expansion of money and credit, and economic authorities may take steps to reduce the 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 important measures in the normal day-to-day operations of markets.

These markets ordinarily perform a number of essential functions, including pricing, allowing numerous transactors 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, in some cases, it may be possible to safeguard against the extreme swings to which these markets seem 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 market behavior that is both harmful and profitable. Swindlers continue to use the “chain letter” method, and their victims are doubtless considerable, and reduce the efficiency of these markets. Yet, in some cases, it may be possible to safeguard against the extreme swings to which these markets seem 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.

Chairman Volcker added in his April 30 testimony, “The question is how to minimize the dangers, arising rarely, without impairing the markets in their useful, even indispensable, everyday work.” The development of policy to deal with such situations remains one of the most difficult challenges for the regulatory authorities.

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

NOTE: No Economic Commentary was published on April 21, 1980.
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 rose more than doubled, and the boom seemed unstoppable (see table 1). As President Calvin Coolidge left office in March 1929, he claimed that the average American had never had such happy times. Yet stock prices were cheap at current prices. Between September 1929 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 1716, John Law, a favorite of the French king, created the Banque Generale, 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 speculative boom. In 1720, share prices rose an average of 10 points per day. Over 30,000 foreigners 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.

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.

Speculative Cycles of the Past

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Gold</td>
<td>$200/ounce</td>
<td>$48.70/ounce</td>
<td>$518/ounce</td>
<td>$34 (index)</td>
<td>Worthless</td>
<td>$200/ounce</td>
<td>$6/ounce</td>
<td>$100/1798 ($520)</td>
<td>$1719/1720</td>
<td>$20,000/1720</td>
</tr>
<tr>
<td>Silver</td>
<td>$6/ounce</td>
<td>$48.70/ounce</td>
<td>$6/ounce</td>
<td>£100/share</td>
<td>Worthless</td>
<td>$6/ounce</td>
<td>$6/ounce</td>
<td>$100/1798 ($520)</td>
<td>$1719/1720</td>
<td>$20,000/1720</td>
</tr>
<tr>
<td>New York</td>
<td>$1719/1720</td>
<td>$1719/1720</td>
<td>$1719/1720</td>
<td>£100/share</td>
<td>Worthless</td>
<td>$1719/1720</td>
<td>$1719/1720</td>
<td>$1719/1720</td>
<td>$1719/1720</td>
<td>$1719/1720</td>
</tr>
<tr>
<td>South Sea</td>
<td>$1719/1720</td>
<td>$1719/1720</td>
<td>$1719/1720</td>
<td>£100/share</td>
<td>Worthless</td>
<td>$1719/1720</td>
<td>$1719/1720</td>
<td>$1719/1720</td>
<td>$1719/1720</td>
<td>$1719/1720</td>
</tr>
<tr>
<td>Mississippi</td>
<td>$1719/1720</td>
<td>$1719/1720</td>
<td>$1719/1720</td>
<td>£100/share</td>
<td>Worthless</td>
<td>$1719/1720</td>
<td>$1719/1720</td>
<td>$1719/1720</td>
<td>$1719/1720</td>
<td>$1719/1720</td>
</tr>
</tbody>
</table>

Table 1 Profiles of Several Speculative Bubbles

2. For a history of these speculative bubbles, see John Carrell, The South Sea Bubble (Cresset Press, 1960).