In this essay consider how political, Macro, and Micro, influences effect the rapid investment into new technologies and the following rapid transition of capital flows into other investments, commonly occurring in economic bubbles’ “boom” and “bust” cycles. Using the principle assumptions of economics we can see not only how bubbles occur from a general perspective, but also how they make good sense from an economic perspective.

“Why do economic bubbles occur?”

It seems that every decade or so a bubble bursts, and the economy is negatively affected. When this happen, as if on cue news anchors, politicians, and the general public, begin to seriously consider the questions “why did this bubble occur?”, “Could it have been prevented?”, “What should we learn from this experience?”, among others. At the current time there are no explicit signs of a bubble bursting, and many people are once again indifferent to these questions. However, I am still curious about the sources of these pernicious phenomena. My curiosity stems from a simple cause and effect relationship: when bubbles burst bad things happen in an economy. Thus, if we understand “why” we can better understand how to manipulate and avoid these scenarios. Hopefully, by re-opening my principles textbooks, and reviewing the current literature I will be able to achieve a more enlightened understanding of the economic conditions that cause bubbles.

First we need a well documented scenario. The Dot-Com bubble happened far enough in the past that there exists sufficient data and literature to review, and is also recent enough for my reader to feel a bit nostalgic. The technology bubble may have begun in the early 1990s and definitely reached a bust around the turn of the millennium. The peak of the technology bubble was on March 10th, 2000, when the NASDAQ peaked to 5153.52. A brief synopsis of the scenario is as follows. The production of new information and computer technologies was expected to usher in huge increases in the productivity of labor (1), in the private and public sectors. These vague expectations surrounding the increase in productivity allowed investors to assume the best for the short term economy. While considering that hindsight is 20-20 and while maintaining the basic economic assumption that people are rational, we conclude nothing other than that people of this time were acting in what they thought was the best manner to secure their economic standing. However, investors’ expectations, rather than their concrete judgment can be seen to be a leading factor in the rapid inflation of stock prices during the technology bubble. How did stock prices rapidly inflate? Here is one theory. If many people started to understand new information technologies as practical and necessary in many different sectors; then, people would have begun to invest in the companies that produced information technologies. Certainly at first people experienced the returns to price ratio of I-T stocks to have been in their favor, others caught onto this logic and there begun a rightward shift of the demand curve(2). “Real fundamentals could not explain the explosion in the U.S. stock prices in the 1990s. Stock prices rose six fold in this decade while labor productivity only doubled.” (Western, 2010, pg. 3)

The expectation of an increase in labor productivity due to new technologies was assumed but never was seen. I have heard some ideas surrounding the slow diffusion of new technologies into an economy. When new technologies enter an economy it requires time for people to learn how to use them -i.e. human capital needs to catch up to new technology (3). If people cannot use new technology there is no gain in productivity. If this idea is correct then we would expect to see a gradual increase in labor productivity over time, rather than a drastic increase over a short amount of time. Investors continued

(1) To clear up some of the economic jargon for my reader while maintaining a concise and academic piece I have decided to provide definitions from Businessdictionary.com. Output of Labor: rate of output per worker (or a group of workers) per unit of time as compared with an established standard or expected rate of output. (BD 1)
(2) Demand Curve: graph curve that normally slopes downward towards the right of the chart showing quantity of a product (good or service) demanded at different price levels. (BD 2)
(3) Human Capital: Health, knowledge, motivation, and skills, the attainment of which is regarded as an end in itself (irrespective of their income potential) because they yield fulfillment and satisfaction to the possessor. (BD 3)
expecting while actual conditions in labor productivity were changing slowly. What ironically may have made this scenario worse was the use of these same information technologies to further open investment opportunities to less experienced investors. Especially, around the time when the Dot-Com bubble busted; at this time all that one needed to invest in stocks was a reliable modem and a bank account that permitted electronic transfers- this concept has been further expanded by many Internet based investment firms today. Lord Keynes recognized this about the nature of human speculation, “It might have been supposed that competition between expert professionals, possessing judgment and knowledge beyond that of the average private investor, would correct the vagaries of the ignorant individual left to himself.” (Keynes 1936, p. 154)

From the writings of more experienced economists we can get a more complete macro-analysis concerning the conditions that caused the technology bubble. A book by David L. Western named “Booms, Bubbles, and Busts in the US Stock Markets”, is one of these valuable sources. The author stems his argument from the frictions involved with political transitions. From ex-presidents George Bush’s administration to that of Clinton’s, “Obviously, Clinton desired growth and prosperity but Greenspan desired growth with stability” (Western, 2010 pg.32). The author elucidates, that Greenspan wished to keep inflation under wraps. The ability of the Federal Reserve chairman to control interest rates, among other monetary policy, restricted the desires of President Clinton to fulfill his political reform. This conflict framed the macro-economic background that the bubble occurred in.

Greenspan may have thought that “by lowering budget deficits and the national debt, pressure could be taken off long-term interest rates” (Western, 2010 pg.32). Thus stuck between political and monetary desires, Clinton had to work frugally. This frugality was marked by the famous “End of big government” ideology, and can be witnessed in the curtailment of the national deficit during Clinton’s presidency. Also, by keeping to Greenspan’s agenda Clinton appeased those in business, by keeping interest rates low he allowed companies to invest in capital more easily. Growth rate in GDP went from near zero in 1991 to 1993’s now considered normal three percent annual growth. The growth in the private sector also resulted in a gradually decreasing unemployment rate. However, while American businesses profits were drastically increasing wages were growing gradually. Moreover, new access to easy credit and optimistic expectations of the future caused rapid increases in the average household debt levels. When people are willing to invest and use credit this indicates that they are optimistic about the long run; they cannot buy that TV now in cash, but they are sure their wages are stable enough to make payments in the future. “Every age has its peculiar folly; some scheme, project, or fantasy into which it plunges, spurred on either by the love of gain, the necessity of excitement, or the mere force of imitation.”(Mackay 1841, p. 354)

At the turn of the millennium I was 11 years old. Many members of my family work with real estate, one thing that I remember hearing constantly was that houses always increase in value over time, and this is why they are good investments. I never hear this today. It still remains as a significant artifact to a fallacy that may cause economic bubbles and busts. A professor once told me that the expectations of most people come from what they have heard, seen, or experienced. The information of the time may have indicated that real-estate always did increase in value over time. If this was the case then every purchaser’s decision to get into a real estate before a bust is logical. Another assumption that economists make is that of completeness. “Completeness” is the assumption that people make decisions with full knowledge of all other alternatives. Therefore, a person who follows the assumption of completeness cannot critique, after the fact, those who made a poor choice, because in fact what we are assuming is that they are making
the best subjectively defined choice at that given time. With these principles in place, we can see how logical people with information that is said to be accurate at the time, when their finances permit, would have invested in real estate at the turn of the millennium, with the common assumption that it is an investment that will always grow in value.

To add to this problem economists also make another assumption regarding people’s choices, which is non-satiation. Non-satiation is a concept that dictates more is better than less. I am sure we can all think of scenarios where this is incorrect, but for goods that we all commonly desire I know very few people who would refuse less to more; who would argue if I gave them a new car, if they did not want it they could always sell it or give it away. In this case of real-estate around the 2000, anyone who was investing would have desired more to less, especially given the assumption of real-estate as a good investment. Thus, in the cases where investors are logical and informed, and they would prefer more to less, and all information at the time tells them to invest, they will invest. This is how people get logically fixed on purchasing goods in a bubble situation. There is no incentive for them to do otherwise. The bubble would then “bust”, when prices of the investment good reach a point where people are less willing to invest. This starts a sudden transition. People begin to realize that their investment stops growing, because fewer are willing to buy. The more bullish investor would move capital out of stagnant investments and into something more profitable. Expectations that suddenly shifted the demand curve rightward are now plummeting them back leftward. In this way the assumptions and principles of economics describes why and how a bubble may occur.

My curiosity than leads me to the ineffable question: What went wrong with are rational economic agents and why are bubbles not preventable? There are three primary ingredients in a bubble scenario: high expectations for the future, assumptions of economic growth in the macro-economy, and rational thought. Rational thought leads investors to invest on a good at any certain time, at least in theory. But as was previously discussed nothing seems explicitly wrong with an investors rational. I believe the logical fallacy is stemmed in my assumption of completeness. Economists have coined the term “imperfect information”. While a person makes a decision at any given time, spectators assuming that the person has complete knowledge of alternatives, does not mean that there are unseen alternatives outside that field of that person’s knowledge, or that the information they have is incorrect. What went wrong with rationality in the case of a bubble? What may have caused the bubble are imperfectly informed economic agents. The problem concerning expectations of the future, can only attest to our own short sightedness. Lastly, the problems concerning assumptions about growth in an economy can easily be dealt with by realizing what many people know- people cannot predict the future.
Works Cited

Books

1)


2)


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Mackay, Charles. 1841. Cited in text as (Mackay 1841, p. 354)

From the Internet

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