

Can Speculative Bubbles Be Managed? An Institutional Approach

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“Bubbles generally are perceptible only after the fact. To spot a bubble in advance requires a judgment that hundreds of thousands of informed investors have it all wrong. Betting against markets is usually precarious at best.” Alan Greenspan (June 1999)ⁱ

“Those of us who have looked to the self-interest of lending institutions to protect shareholder’s equity (myself especially) are in a state of shocked disbelief” Alan Greenspan (October 2008).ⁱⁱ

These two quotes may be seen as bookends to the bubble economy of the last decade or so. They indicate the Federal Reserve’s reluctance to inhibit the irrational exuberance of investors at the beginning and its alarm that, after the fact, market forces had allowed two successive bubbles to happen at all. This faith in the judgment of the market and self-interest of bankers as a self-regulating force will be referred to as market fundamentalism in this essay. Market fundamentalism, I will argue, is poorly suited to diagnose or prescribe a remedy for bubbles. I will argue further that it is market fundamentalism that underlies the Fed’s role in inflating the bubble economy and its reluctance to restrain it. My goal is to explore how such an ideology was adopted and the confluence of ideas, interests, and events that explain its adoption.

The underlying premise of the essay is institutional, i.e. that organizations are constituted by the narratives, logics of action, and ideologies that exist in a particular field (Phillips, et. al. 2004). My argument relies on work in organizational and historical institutionalism that shows how economic and managerial theories come to be adopted in both private and public sector policy making (Weir and Skocpol 1985, Hall 1989, Guillen 1994, Campbell 1998). Following Campbell (1998), the argument shows how an idea, in this case market fundamentalism, can both constrain and enable the policy making process. Although this argument has echoes of Keynes’ famous observation that policy

makers “are often the slaves of some defunct economist” (Keynes 1936:383), it does not grant sole influence to talented academics and their ideas. Rather, it explores how the choice of ideas adopted may be affected also by the nature of national political discourse, the receptiveness of State structures, and the goals of ruling political parties. These institutional pressures, when taken together, help to explain why a bubble economy may still occur despite the existence of the knowledge and organizational capacity needed to inhibit it.

This essay is organized around three questions: What do we know about speculative bubbles? Why do they still occur? Can they be managed? Before proceeding to explore the latter two questions, however, I will introduce various analytic perspectives that have been used to explain speculative bubbles. For our purposes, bubbles will be defined simply as a condition in which “prices are high ...only because investors believe that the selling price will be high tomorrow –when ‘fundamental’ factors do not seem to justify such a price” (Stiglitz 1990: 13). I will argue in the following section that market fundamentalism obscures what we know from historical experience and alternative models.

Modern Bubble Theories

Market Fundamentalism – The most influential approach to understanding asset markets today may be referred to as market fundamentalism. As stated above, it is an exaggerated faith in the ability of the market to achieve socially optimal outcomes. It is

not one idea, but a system of interrelated ideas that offer predictions, diagnosis, and solutions. This faith is seen in its strongest form regarding financial markets. Block (1996) identifies three basic assumptions underlying what he calls “the conventional wisdom.” First, financial markets are excellent at pricing assets. Second, money will flow to markets with the highest return within and across countries as long as they are tightly linked. Third, the regulation of financial markets should be kept to a minimum to avoid interference with the market mechanism.

In the strong form of market fundamentalism, often associated with the efficient markets hypothesis, asset prices always reflect the asset’s true value, leaving no room for the existence of bubbles. Any major price swing is explained as a response to an exogenous shock that changed the fundamental underlying value of the asset. This position is reflected in the work of Flood and Garber (1980, 1990a, 1990b). They studied the Tulipmania in Holland and the South Sea Bubble in France and England, two of history’s most famous bubbles. They found that they were not bubbles at all, but rational responses to changing conditions. Following the critiques of this work by Canterbury (1999) and Baddely and McCombie (2001), it does not appear that rapidly rising prices reflected a sudden increase in the desire for tulips or the rational expectation of earnings by the South Sea Company. Also, the collapse in prices over a period of days and the government intervention that followed suggest a crash rather than a standard pattern of price depreciation. In sum, prices did not reflect a rational assessment of fundamental value.

In its weak form, market fundamentalism, as seen in Alan Greenspan’s quotes above, generally accepts that bubbles may occur in rare instances. In these instances,

values are distorted by some exogenous shock to the market. But as Greenspan explains, you can't tell that it was a bubble until after it's popped and it's better to trust the judgment of investors and bankers than to act to inhibit the exuberance. The weak form is best represented by the work of Kindleberger who argues that bubbles are the result of exogenous shocks leading to a mania fueled by destabilizing changes in the supply of credit (Kindleberger and Aliber 2005). The three major weaknesses in this kind of thinking are 1) its reliance of exogenous shocks obscures the endogenous weaknesses in the market 2) its assumption of equilibrium leads to a functionalist search for the source of disturbance, and 3) its psychological reductionism that conceals the role of institutions in speculative bubbles. The next two theories speak to these weaknesses.

Financial Instability Hypothesis – This model was developed by Hyman Minsky (1986, 1993)ⁱⁱⁱ. Only since the collapse of the housing bubble in recent years has it come to prominence. The congruence of current events with Minsky's model has made "Minsky moment" a catch phrase on Wall Street. Rather than assuming that bubbles require an exogenous shock, Minsky saw that such instability was part of the internal dynamics of capitalist economies, i.e. endogenous to the system^{iv}. Minsky posited that the economy has financing regimes that range from prudent to Ponzi (Minsky 1986: 230). "Over periods of prolonged prosperity, the economy transits from financial relations that make for a stable system to financial relations that make for an unstable system" (Minsky 1993: 8). Periods of stability encourage more risk taking and innovation that increases income even as it disrupts the conditions that generated the system coherence and stability. This is not a system in which the individual pursuit of self-interest leads an

economy to equilibrium. Rather, “tranquility” encourages more risk-taking and innovation, which, in turn, creates endogenous, deviation-amplifying de-stabilizing forces.

Recently, Papadimitriou and Wray (2008) have applied Minsky’s model to the current financial meltdown. As they explain, “ the financial innovations of the past decade greatly expanded the availability of credit, which then pushed up asset prices. That, in turn, not only encouraged further innovation to take advantage of profit opportunities but also fueled a debt frenzy and greater leveraging.” They show how a series of profit opportunities increased the appetite for risk and “tipped the balance of sentiments” from fear towards greed. The greatest strength of the Financial Instability Hypothesis is its recognition that instability is the result of internal processes of the finance capital. Minsky shows that twenty years of post-war stability from 1945 to 1965 were followed by a series of near crises (1970, 1974-1975, 1979-80, 1982-1983) that reflected the system’s increasing fragility. Although the Financial Instability Hypothesis has much to recommend its explanatory power, it contains two weaknesses. First, is the model’s psychological reductionism. Minsky tended to rely, especially in his early versions of the hypothesis, on terms like euphoria, mania, distress and other Keynesian “animal spirits” to explain the instability and deviation and amplification. A second weakness is an economic functionalism that makes bubbles seem over-determined. These issues are addressed in a third model.

Social Construction Perspective – This model was first developed in Abolafia (1988, 1996). In its current version it also draws on Akerlof and Romer (1993), Barron (2007)

and Ferguson (2008). It shares with Minsky's model the sense that bubbles are endogenous to the system and that the economy or, in this case political economy, goes through different financing regimes. But in the social construction perspective, individual economic activities, such as speculation, are enacted in the context of the social relationships, cultural idioms, and political and economic institutions. These social phenomena define the market, rather than the reverse. Thus, it is the market professionals pushing innovations and insider speculators who create the bubble, rather than the irrational herd of manic victims.^v In the same vein, it is state sponsorship of easy credit and lax regulation that enacts instability, rather than the deterministic consequences of too much stability. In other words, markets work because of the structure of formal and informal constraints constructed to tame them. Without this social infrastructure, markets are self-immolating.

The social construction perspective emphasizes the speculogenic structural conditions that facilitate bubble construction by market professionals and insider speculators. Comparative historical research suggests that speculative bubbles have three recurrent features. The first is the creation of financial innovations that have forms of information asymmetry that the insiders can exploit fraudulently (Ferguson 2008, Akerlof and Shiller 2009). In recent years these have included securitization and off-balance sheet accounting. The second feature is lax regulation and low penalties. These failures of the state signal market professionals that they are free to test the limits of opportunism. The final necessary feature is easy money. All bubbles occur under conditions of easily available credit. In the current bubble economy, this has meant prolonged periods of low

interest rates. Both Federal Reserve policy and the glut of Chinese investment have contributed to this.

Why Do Bubbles Still Occur?

I have no illusions that the Social Construction Perspective is going to be adopted by our economic policy makers. Either the Financial Instability Hypothesis or the Social Construction Perspective is adequate to manage speculative bubbles by providing guidance for policy makers to inhibit speculative excess. Even if these ideas remain outside the dominant paradigm, policy makers still have economic history and institutional memory to remind them of the legacy of past bubbles and their consequences. But history is notoriously ignored and institutional memory is undependable as older members leave the organization. Although policy makers were fixated on not repeating 1929 during the postwar years, by 1980 it was the Great Inflation rather than the Great Depression that was foremost in their minds. It was at this historical moment that market fundamentalism came to be the dominant ideology. In the following section I will discuss how market fundamentalism came to pervade American economic policy making.

This is an argument about ideas and policy making. But, it will not claim that ideas alone determine policy. Rather, I will show that ideas are in a constant interplay with interests and events. Ideas, as Weber indicated, can often embody the interests and events of the moment, creating a new image of the world and switching the direction of history (Gerth and Mills 1946). The institutional approach used here identifies three

factors influencing the adoption of ideas. These factors reflect the power of organized actors, e.g. professions, political parties, and technocrats, to create institutional pressures on national economic policy. In this essay I focus on policy making at one organization, the U.S. Federal Reserve. During the recent bubble economy, the Fed has been responsible for controlling the money supply and regulating the largest bank holding companies. It is central to understanding the enactment and management of bubbles.

The Role of Professional Economics – Economic concepts and models play an important role in economic policy making. Like management theories, these concepts and models are used in at least two different ways (Guillen 1994). First, they offer policy makers a body of technical knowledge that can provide a filter for sifting through information and a script for identifying and selecting among policy alternatives. Second, the concepts and models constitute an ideology “aimed at establishing legitimacy and reinforcing credibility” (Guillen 1994: 3). They contain the basis for agreement on the justice and reasonableness of the social order (Heilbroner and Milberg 1995). This second use is of particular importance when policy making is highly visible and controversial. Such ideologies usually lie in the background of policy debate as tacit assumptions (Campbell 1998), although they may rise to the foreground, as in the following excerpt from a Federal Reserve policy meeting from the 1990s in which an unresponsive economy forced policy makers to re-consider the current orthodoxy.

MR LINDSEY. Twenty years ago I was sitting in freshmen economics with Samuelson's Eighth Edition, and the first thing we were taught was something called the "paradox of thrift." The paradox of thrift was the 1972--or probably the 1952--way of saying "balance sheet restructuring will lead to

less economic activity." ... Well, we've been trying to unlearn Keynesian economics for the last 20 years and that may have been a mistake because, in fact, I think it's probably very close to the situation we're in now ... (FOMC 1992: 37).

This questioning of assumptions reflects the fact that the consensus on Keynesianism consensus had dissolved in the 1970s and competing versions of market fundamentalism had risen to fill the vacuum. Heilbroner and Milberg (1995) identify four analytical weaknesses in Keynesianism that led to its unraveling within the academic field of economics. First, was its inability to offer a theory of inflation. Its one effort, the Phillips curve, was thoroughly discredited in a series of papers by Friedman (1968), Phelps (1967), and Gordon (1972). Second, was its failure to predict or explain the stagflation that plagued the United States in the 1970s. Third, was the relatively limited efficacy accorded monetary policy. Monetarists and other market fundamentalists took this as a direct challenge, especially in a period of inflation. Finally, Keynesian behavioral assumptions about the macroeconomy, the animal spirits referred to earlier, are at odds with previous and current rational maximizing assumptions of microeconomics. All these weaknesses opened the door to an assault on Keynesianism, an effort by policy makers to “unlearn” it, and a return to the market rather than the state as the solution to problems. Although this return might well be expected from America’s history of economic policy, its character was shaped by factors discussed below.

The Nature of National Political Discourse – Policy making takes place within the context of prevailing political ideas (Hall 1989). These ideas reflect culturally popular notions about such things as the appropriate role of government, the efficacy of

markets vs. the state as solutions to social issues, the salience of competing values, and the shared interpretation of past successes and failures. There are times when a dominant discourse emerges. At its most coherent, such discourse becomes a program (Campbell 1998), a policy prescription that guides policy makers to a course of action. Such a program, in the hands of skilled leaders, may become a tacit part of public sentiments, a set of normative assumptions about what is politically acceptable and legitimate (Campbell 1998).

Starting in the mid 1970s, during the Carter administration, the nature of political discourse began to shift toward de-regulation of the economy and market-centered policy making. This discourse was a response to the steep recession of 1974-1975 and the stagflation mentioned above. There was a congruence between ideas and circumstances. Under President Reagan, a master communicator, these ideas had a skilled interpreter. The de-regulation movement escalated into frenzied anti-statism (Block 1996). The discourse of anti-statism held sway for nearly thirty years. At the Fed, policy makers adopted a form of monetarist policy to bring down inflation. The policy had newfound legitimacy because it presumably reduced the discretion of policy makers and trusted the rationality of the market. Later, under Greenspan, the Fed loosened regulation of the banking sector and took a laissez-faire attitude toward irrational exuberance as described in the quote at the beginning of the essay. Greenspan was a master of framing, explaining soaring value of stocks in the dot.com bubble as reflective of increases in productivity. National Political discourse became resolutely market fundamentalist and skeptics were marginalized.

Receptiveness of State Structures— Economic policy is most often understood as the outcome of interest groups or class politics. Institutional theorists (Hall 1989, Weir and Skocpol 1985, Campbell 1998) suggest how the state and the structure of its agencies may become vehicles for the adoption of ideas and models in their effort to create coherent reactions to policy problems. In recent work (Abolafia, forthcoming), I argue that monetary policy is increasingly the work of relatively autonomous technical experts in government. Control over Fed policy making has shifted over the course of its history from bankers to economists. From its establishment in 1913 to the Great Crash, the Fed was controlled by the regional reserve banks, especially the one in New York. During and the Depression and the Second World War the Fed dutifully responded to the policy needs of the Treasury. In 1951, the Treasury-Federal Reserve Accord gave it relative autonomy from the executive branch. In 1960, none of the governors of the Federal Reserve were economists. In 1970 four of the seven were and by 1980 all but one were economists. By the time of the bubble economy, the shift from bankers to technical experts was accomplished.

With the Keynesian unraveling, particularly the discrediting of the Phillips curve, the technical experts at the Fed fell back on the standard tool kit of the neoclassical paradigm, just as their colleagues in academia did. At the same time, the discrediting of fiscal policy seemed to leave the Fed in charge of the economy. The critique of Keynesian demand management was congruent with the Fed's capacity for managing the money supply. This unintentionally concentrated more authority in the Fed and put it center-stage. By 1999, the passage of the Financial Services Modernization Act and the chairmanship of Alan Greenspan, a market fundamentalist by inclination, insured that

banks would enjoy lax regulation and bubbles would not be spotted in advance. The Fed became increasingly reluctant to follow former Chairman Martin's dictum that its job was to "take away the punchbowl just when the party gets going."

Conclusion

This failure of the Fed to do its job brings us back to the original question, "Can speculative bubbles be managed?" My answer is yes and no. "Yes," because we have the knowledge needed to inhibit the worst excesses of a speculative binge. We know that extremes of lax regulations with low penalties, information asymmetries in financial innovations, and easy money are the conditions making economies susceptible to bubbles. Indicators of trading volume, proliferation of new instruments, leverage levels, and market participation by newcomers can all be monitored. Strengthening regulatory agencies and practicing more vigorous countercyclical monetary policy are well within current organizational capabilities.

But, in the end, I will favor "no" because it seems likely that the institutional factors identified here will be a repeating motif in capitalism. The discourse of market fundamentalism may be repressed, as it was in the Keynesian revolution, but it is likely to re-emerge and be championed by institutional entrepreneurs like Ronald Reagan and Margaret Thatcher, backed by political and economic interests. The inertial strength of this discourse may be seen in the current political difficulties of the Obama administration. Institutional factors, as we know, don't change easily. Major changes in economic policy call for shifts in academic economics and regulatory practice supported

by an institutional entrepreneur with consummate rhetorical skill and impeccable timing.

At this point, radical institutional change does not seem probable.

ⁱ This quote is taken from Greenspan's appearance before the Joint Economic Committee of Congress in June of 1999. Cited in Zandi 2009: 70).

ⁱⁱ Testimony of Alan Greenspan, Committee on Government Oversight and Reform, U.S House of Representatives. October 23, 2008.

ⁱⁱⁱ Minsky reworked this model many times over his career. As a Keynesian, Minsky's early models assumed exogenous shocks (displacements). We rely, therefore, on the later work.

^{iv} It is worth noting that a considerable body of research in experimental economics supports Minsky's contention that bubbles are endemic to asset markets (Smith et. al 1988, Haruvy et.al. 2007, Hussam et. al 2008).

^v This finding is supported by the research in experimental economics cited above.

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