Spain’s Economic Development in the EU (MoWe 16:45)
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Castles in the Air; Human Crowd Psychology

Introduction

Market price, in theory, should reflect the marginal cost and marginal utility for a product or service. While economic models and theories are very useful for understanding trends and the inner mechanics of economies, history has proven that in reality there are many other forces at work as well.

Naturally, economies function as networks of people operating on self-driven motives and goals. When this is the case, market forces are at the mercy of what is happening in the minds of the individuals making up the whole. Personal incentives are involved and people tend to have a myopic view of the system as a vehicle to personal gain. Because of these properties, markets can be subject to imperfections that have tangible repercussions impacting not only the decision makers but the bystanders as well.

Asset bubbles are one such imperfection, stemming from speculation related to future gains rather than an analysis of price to perceived value. Throughout history, this phenomenon has manifested itself in a wide variety of forms and can explain many problematic economic events from as far back as the 1600s to the Dot-Com Bubble in 2000 and the Subprime Mortgage Crisis in 2008.
Although we have a better understanding of financial manias now than we did in the 1600s, they continue to affect our global economy and still arise when investors are not prudent. Just this year in 2018, we witnessed one such bubble with the Bitcoin cryptocurrency which we will discuss in more detail. Investors lost control of hopes and allowed prices to spike before taking a deep decline. For this reason the topic is highly relevant in today's business world, as the more we understand and can easily spot these imperfections the more our markets can be alleviated from their repercussions.

**Human Crowd Psychology Behind Market Imperfections**

According to John Maynard Keynes, people are "largely concerned, not with making superior long-term forecasts of the probable yield of an investment over its whole life, but with foreseeing changes in the conventional basis of valuation a short time ahead of the general public."

The “Castle in the Air” theory of asset pricing helps explain why some assets rise in price far past their actual value. It states that an investment is worth a certain price to a buyer because they expect to sell it to someone else at a higher price. In a sense, this means that the asset is “holding itself up by its own bootstraps” MALKIEL (2003). Each buyer carries the assumption that a future buyer will value it even more highly.

This strategy can play out well for investors who climb aboard early, and are able to make a profit based on this speculation. Logically, it makes sense to “pay three times
what something is worth as long as later on you can find some innocent to pay five
times what it's worth" MALKIEL (2003). Like a Ponzi scheme, this system has to end
somewhere at the expense of someone. This is why the idea is also called the “Greater
Fool Theory”.

Whether it is a conscious investing strategy or simply emotion driving a purchase
based on the profits of others, this is the thinking that drives the creation of an asset
bubble. Hopes and expectations continue to rise, but not much thought or consideration
is given to the actual value of the asset itself. With focus on the future and not what
exactly they are building, people soon find themselves not with a sound investment but
a castle in the air.

Tulip Mania - The Tulip Bulb Crisis of 1637

An early and illustrative example showcasing the power of human psychology in
economics in simple terms is a speculative bubble surrounding tulip bulbs in the
Netherlands during the 1630’s. It began when tulips were brought from Turkey to the
Netherlands for a professor in the mid-1500s. When bulbs were stolen by a thief, they
disseminated throughout the country. They grew in popularity, and soon became
subject to a nonfatal virus called Mosaic that imbued the flowers with extravagant
patterns.
Bulbs with the most beautiful patterns became the most valuable, and demand began to rise quickly. Merchants scrambled to gain footing and purchased stock to fulfill demand. As the prices for the bulbs started to skyrocket, they were increasingly viewed as an investment rather than just a simple good. It became logical to purchase the bulbs even for a high price, because of the constantly rising value and promise of a return without end in sight.

Investing in tulips became so common and lucrative that it was almost considered a no-brainer, bearing consistent and unrelenting returns. Securities became a popular way to buy and sell the asset, and investors were able to trade them using call options. All types of people in Holland invested money, rich and poor, but it didn’t stop there. Certain bulbs became so valuable that people traded land, jewelry and furniture for them. It was at this point that the bubble became particularly dangerous, with average people putting their savings and property on the line for tulip bulbs.

The tulips reached such a high price that it created laughable and bizarre situations. The most notable of which involves a sailor who was an overnight guest at an estate. When he woke up in the morning, he was served a breakfast of salmon and eggs. Looking for something to garnish it with, he found what appeared to be an onion and used it to complement his food. To the homeowner’s horror, it turned out to be a very valuable tulip bulb. The bulb that the sailor consumed was equivalent in value to the supplies needed to operate his ship for a year’s time. Rather than forgiving their
houseguest’s mistake (tulip bulbs do look very similar to certain onions), the owners had
the man imprisoned on a felony charge.

Eventually, there reached a point where people were either satisfied with their
returns or began to doubt the continued rising future value of the bulbs. As supply
increased, the price began to drop. As people saw the price starting to fall, they
scrambled to divest and created a chain reaction. The decline accelerated and price
began to plummet.

Fearful of the repercussions, the Dutch government attempted to step in. Their
plan was to honor the contracts at 10% to prevent total loss and calm the market down,
but they only stirred up more panic among the people and drove the price down further.
The added hit to price made the scheme too expensive for the government to execute
and the loss continued.

The rise and subsequent fall of tulip bulbs had a lasting effect on the Dutch
economy. Troves of assets and pledged debts became worthless and spread
bankruptcy. People from all social classes in the country lost fortunes, and ultimately the
ordeal caused bankruptcy and a prolonged economic depression throughout the
Netherlands. Since this is one of the first recorded asset bubbles in history, investors
and government officials did not have the benefit of prescencient knowledge and could
not effectively understand or react to the phenomenon until it was too late.
The BitCoin Bubble (2018)

The U.S. has witnessed many asset bubble crashes during the last 100 years and you would think that we would be able to learn from our mistakes. Unfortunately, human behavior remains the same and bubbles are still being created by opportunistic investors and speculators, causing price increases not supported by market fundamentals. However, the real trouble occurs when everyday people, many of whom have little to no investment experience, take notice to the rising asset and decide that they want a piece of the pie. The flood of new investment dollars results in an asset with even more inflated and unsustainable levels. Eventually, demands becomes exhausted and prices fall precipitously. The Tulip bulb crisis was one of the worst asset bubble crashes in history, but some speculators say there is currently a bubble that dwarfs the tulip mania from 400 years ago, that asset being bitcoin.

Most people think of bitcoin as a fairly new cryptocurrency. However, bitcoin has been available since 2009, the year when Bitcoin software was made available to the public and the process of mining (new bitcoins are created and transactions are recorded and verified on the blockchain) began. Once the cryptocurrency started to be traded in 2010, bitcoin was first valued at just 6 cents a share. As investors started to take notice in Bitcoin, the price rose rapidly leading to what is called hindsight bias. Hindsight bias is the tendency for people to overestimate their ability to predict the future based on the recent past (Nash, 2013). Investors and speculators saw a short
term trend in Bitcoin, so they extended that forward into the future with higher confidence that the data would mathematically support.

In 2017, Bitcoin rose almost 450%, reaching a peak of $19,783. During this time, success stories began to spread across social media and regular, everyday people began to invest in bitcoin. But why would normal people who have never invested in an asset all of a sudden take a risk on something like Bitcoin? The answer has to do with herd behavior. We are biologically wired to mimic the actions of the larger group. While this behavior allows us to quickly absorb and react based on the intelligence of others around us, it also can lead to self-reinforcing cycles of aggregate behavior. In this euphoria stage, people buy because others are buying and because they anticipate being able to sell quickly at a higher price. For a while, this trend is self-reinforcing due to overconfidence by buyers. However, at some point, doubts set in and people start to sell in an effort to make a profit while there’s still time.

Once the price starts to fall, the psychology changes. People who bought early and were counting their millions suddenly see a dent in their wealth. Other people may have bought above the current price and are bitterly regretting their mistake. Bitcoin is likely in this stage of doubt as today the price of Bitcoin has dipped under $7,000, a drop of almost 65% from its peak in 2017. As the confidence for bitcoin fades, more people will try to get out while they can, eventually leading to an asset bubble crash. “The wheels are coming off the bitcoin bandwagon,” said Neil Wilson, analyst at ETX
Capital. “The regulatory crunch appears closer than ever and sooner or later this market could be headed back down to earth. Selling pressure at the moment is intense as there has been nothing but bad news for bitcoin bulls of late. Trying to catch the falling knife is a risky game (Monaghan, 2018)”. While there are some who deny bitcoin being in a bubble at all, only time will tell what the future holds for this cryptocurrency.

Conclusion

After two massive bubbles in the U.S. in less than a decade, many people wonder if there will ever be a way to catch bubbles before they crash. In every bubble, a number of people do correctly identify the bubble. As in the story of the boy who cried wolf, however, the truth is apt to be disbelieved. The problem is that in every market, there are always people claiming that prices are too high. That’s what makes a market. As a result, the cry of “bubble” is far more often proven wrong than right. Every potential bubble, however, provides an incredibly valuable frame for deepening and debating the role of human psychology in financial markets.

Works Cited


http://fortune.com/2018/02/02/bitcoin-bubble-burst-trouble/

