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**Does on bubble lead to another?**

John Redwood

Good afternoon, ladies and gentlemen, and thank you for that warm welcome.

I am not here as a Conservative MP; I am here as John Redwood, perhaps best defined as the author of [www.johnredwood.com](http://www.johnredwood.com), which tries to provide a daily commentary on the follies, foibles, successes and failures of the financial and economic world. There has been plenty to write about in recent years.

Our topic is: “Will there be more bubbles?” and the answer is, yes, there will be more bubbles. If you missed the last one, worry not – there will be another bubble along anytime soon!

There are certain characteristics which bubbles have in common: there is often a banking and a financial base to the bubble; there are sinews of the bubble, the money that is pumped in; but there is also a psychology, and we see that the psychology becomes addictive. A limited number of people start off with the good idea of ramping a price, and if they are really successful, three or four years later, they have ramped it beyond riches and dreams of avarice, and suddenly, all the books are rewritten, justifying why this price has been singled out and why it has gone up.

If we had been meeting in 1638 in Amsterdam, we would be discussing how serious the collapse of the tulip market might prove. By about 1637, one of the then-recent bubbles had developed spectacularly, and a series of wealthy merchants and enterprising people in Amsterdam, that successful *entrepôt* of the day, had decided that tulip bulbs were the most prized way of displaying and keeping their wealth. They had built a mighty market. They had pioneered some of the techniques we are now used to, and maybe even love, including forwards and futures, so that they did not even have to take delivery of the individual tulip bulbs (they were so valuable, there were security problems with them). They asked, themselves, why not just trade a piece of paper? That very elaborate development was, of course, confounded, as suddenly people said, “But these are just tulip bulbs…they grow into flowers and then waste away – why are we treating these as a great store of value?” As a result, the bubble burst.

There are some modern historians who say it was not a serious bubble at all and that not too many people lost too much wealth, but I prefer the original story. I think it was one of the early bubbles, and it is so good because it seems quite preposterous that people could think that tulip bulbs were a good store of value because they have not been subsequently. I do not go to my neighbours’ houses and find a treasured tulip bulb in a glass case in a prominent position in their reception room, simply because we no longer think they are magic. We might keep a few in a dirty pot in the kitchen, but they are not worth very much.

That bubble did not come again, but others have done. We think that gold has great value. It is not a very useful metal. Some people think it is very pretty, others are not quite so sure. But that bubble does come again; there are waves of enthusiasm for gold, and its proponents always argue that gold is much less bubble-like because it is really money. Some people consider it the only true money because it has often been used in money systems in the past and, until 1971, it was still the core of an important part of the paper currency world which grew up in the 20th century.

So, we see that perceptions change. Psychology is an important part of bubbles. What people think is valuable, it matters, it has an impact.

Towards the end of the 1980s, as a very young man I hasten to add, I went to Tokyo. I was there before people thought that Tokyo property prices were excessive and before they thought that Japanese share prices were excessive. The Japanese stock market peaked out at the end of 1989, at an index level of just under 40,000. It is currently well under 10,000, so more than three-quarters below where it was 20 years ago, and it has never got anywhere near 40,000 over the ensuing 20 years. That is a pretty good bubble. People made good money, if they remembered to get out. They then lost a lot of money if they did not, and those who came in near the top were of course burned extremely badly because they were faced with the unpleasant downside.

When I was there, there was euphoria in the air, and the psychology had changed. Everybody who was a serious commentator thought that Japan was going to knock the United States of America off the top perch. They were so impressed by the dominance of the Japanese industrial and trading companies, so impressed by the size of the Japanese banks, so impressed by the luxury quality and price of the Japanese property market, that they were quite sure that Japan was going to topple America. If anyone looked at the population figures, it required quite a leap of imagination to think that the Japanese economy was going to become bigger than America’s, but it was mood, it was sentiment, it was emotion. They knew it was going to happen. America looked rather silly: it was old, tired, the President did not seem to be communicating the right message. He went to Japan and made a mess of it all, and the Japanese were extremely impressed by their own success and by their relative strength.

In the course of my discussions and meetings, I was driven past the quite extensive grounds of the Emperor’s Palace, and my Japanese host said, “You see that piece of real estate there? Well of course, I’m a good loyal royalist and the Emperor is going to live there in perpetuity and it’s wonderful to have it in the centre of Tokyo, but just imagine if it were a development site. That site, the Emperor’s gardens, would be worth more than the state of California.” Now, he was very friendly and I did not wish to insult him, so I waited until I got back to the UK Embassy, amongst my own advisors, before giving them the quip I wanted to give to my Japanese host: “I think it’s time to sell the Emperor’s Palace and to buy California.” If only one had been able to do that, it would have made me an extremely rich man. Of course, I was not allowed to deal in anything at the time, so I quite properly did not. But it was such an obvious moment; it was as if they rang a bell at the top of that market, making these people say these extraordinary things.

Of course, the next decade threw up the next bubble: the technology companies of California. While the real estate prices of Tokyo were crumbling, and for the next twenty years, the industrial real estate of California was being bid up; America turned out to be the future, not the past. America turned out to be the aggressive applier of the digital age rather than the failing superpower, outclassed by Japanese excellence and industrial might.

This shift depended, once again, on mood. The markets suddenly realised that they had missed out on technical innovation in the late-‘80s, early-‘90s, but now saw that America were onto something. She had gone digital. Japan cannot do digital, it has rather a restricted capacity for self-criticism. Japan proceeds by very small, incremental moves, and ultimately has to copy the great, blue-sky advances that only the Anglo-Saxons are capable of. The Brits are capable of them and give away the commercial application, and the Americans are good at not only developing them but also making money out of them. As a result, we experienced the phenomenal ‘dot.com’ bubble.

The Japanese bubble was one of the most spectacular ever. Some people say that a square metre of prime real estate went for a million dollars in the Japanese bubble. Again, how could people believe that this was feasible, realistic or sustainable? But they did, because the popular mood suggested that Japan was going places. Everybody needed to be in Tokyo, and if you were anybody, you needed to be in that really prime piece of real estate in Tokyo. If you could not have the Emperor’s Palace, you had the next best thing.

The markets then did the same thing to American technology and, towards the end of the ‘90s, we witnessed a spectacular boom in the NASDAQ; people began writing stories about the Four Horsemen of the NASDAQ. They should have considered that choice of image more thoroughly, because those Horsemen did not always bring good news, I seem to recall! However, in those days, the Four Horsemen were so excited by the idea of the digital revolution and by the internet age – perhaps rightly so – they forgot all their commonsense about business. Just as people in Japan forgot that no credible business can be run out of real estate at a million dollars a square meter, because customers cannot afford it, so people at the end of the 1990s forgot that you cannot build a business out of hope and excitement alone. They were sitting up businesses to do things on the web, to be defined or to develop only after you had parted with your money. I remember reading a book that explained to me how old-fashioned I was for thinking that businesses needed customers and revenue and cash flow and, preferably, profits. The book informed me that we have not got time for all that! You raise the money, you explain the concept and you burn the cash. They had serious analysts writing articles about the cash-burn rates of these companies, not to say that you should not go anywhere near them until they had stopped burning the cash, but to say that this one has got a year’s cash-burn and it will probably work, so just go for it, and people paid ever-crazier multiples – in fact, of course, all the multiples were infinite because there were no profits – in order to get in to these strange companies.

Some ten years on from the crash, we now know that the broad idea was right, that the internet is a revolutionary and dynamic technology, and it will be possible for some people to make a lot of money out of it, and it is necessary for all of us to use it as a business tool, and so there are big revenues. We now know that there were some winners from those heady days. Some did manage to burn their cash sufficiently intelligently to build a lot of supporters on their list and then make those supporters pay. Others are still finding it difficult to make the transition from having thousands or millions of people signed up to their website to actually getting them to pay for the privilege, and we see the sort of tragic struggles in the media industry at the moment over whether you can get people to pay a realistic price for what has been free goods so far on the web, which you would be prepared to pay for if it came in the printed form on paper.

So, we saw there was a bubble which was half-right but catastrophically wrong, and after 2000, there was an enormous collapse in the share prices of many of these firms. You had perhaps as many as half of them going bust, so people lost all their money in them, and the NASDAQ fell back from a very high level of about 5,000, to a fraction of that, and has stayed at that fraction ever since.

Now, we are interested today in whether we are still in a bubble, and if so, what might happen to that bubble. Indeed, I have been set the particular question of “Does one bubble lead to another?” I think there is a serious problem that one bubble can often lead to another, and if we look at this long credit crunch, I think it is all the same crisis. We may well be in the Euro sovereign debt phase of it at the moment, or it is still part of the same banking crisis, with just different assets going wrong. But I think you need to go back to 2004/2005, with the build of the original bubble, to try and understand where we have now got to as the crisis evolves, because the bubble has not been completely punctured – parts of it have, parts of it have not. The argument today really is: do you go around puncturing more bits of the bubble, with the danger that you collapse everything too far and too fast, or do you extend and pretend and keep bits of the bubble going, in the hope that it generates real activity and real profit and you trade your way out of it? That is always the dilemma. We are trying to manage the aftermath of a bubble. We are trying to deal with perceptions when perceptions have started to change in a negative direction.

If we look at how we got there, it is popular at the moment to say it is just wicked bankers. Now, I do not think it is as simple as that. I am sure there are some wicked bankers; there are wicked people in all sorts of professions and activities. But I do not think bankers, as a whole, set out to cause enormous damage. They were part of a system. And I think, just as there was obvious evidence of bad and rash banking in the 2004-8 period, I think there was very clear evidence of bad and rash central banking. They, after all, are meant to be the regulators, the callers of the tunes, the moderators of the amount of money, and I think there was clear evidence of poor banking regulation by the regulators. Why on earth do we have a large number of pretty well-paid banking regulators if they cannot spot that kind of problem and put in the necessary measures to control it? So, when we see the huge expansion of bank balance sheets in the run-up to 2007/8, we do need to ask not just “Why did the directors of those banks think that the normal rules of banking prudence were suspended?” but “Why did the regulators regulating those banks think the normal rules were suspended?” because they allowed them to do it, or even endorsed what they were seeing. We need to ask why the central banks provided the liquidity, the market assistance, so that they could perform like that.

When I was a financial regulator, responsible for the non-bank financial services sector, I kept in touch with the Bank of England. In those days, I think we thought anything over twenty times leverage was getting a bit too racy and that you wanted to keep the average to twenty or below, and if you had a few outriders above the twenty, you would be asking them very serious questions and getting them – confidential discussions of course because you do not want to undermine confidence in the markets – in order to manage the position.

We have been through a period when regulators have behaved very differently. They seem to like discussing it with the media, which I think is a very dangerous thing to do if you are a regulator. By dragging it into the press, you undermine confidence if you have to make unpleasant comments on the people you are regulating. But at the same time as doing some of this negative copy in the media, they were allowing the UK banking system to have 34 times leverage. Now, why was it that people thought you could go from the old twenty, which we thought was just about prudent, to 34, without any adverse consequences?

It is just like the tulip mania or the Japanese real estate. When people start saying the world has changed, you should ask some very serious questions! Sometimes, the world does change. Sometimes, it changes for the better, which is wonderful. But a lot of times, it does not change as much as people think or the old rules are not always as silly as they look. And just as people in Japan said something like, “oh well, we are so good now that we can afford these sort of property values”, and just as they said, “oh, our companies may be on 100 times earnings but we account in different ways from America and Britain – there is nothing wrong with us being on 100 times and you being on 15 times – you just make the adjustments and it is all fine”. You even had highly-paid analysts claiming that they were not really on 100 times at all, so you had lots of people in 2006/07, in the regulators as well as in the banks, speaking off the common hymn sheet. From it they read the same idea that, it was all different – “we now have such wonderful ways of managing and regulating risk, and these mega-banks are so big that they have got this wonderful average portfolio, it cannot all go wrong at the same time, so what does it matter if they have got a lot of risk on UK property, because it is a small proportion of their total and that will be offset by the profits they make on commodity speculation in Hong Kong and there is absolutely no problem with this, so you are very old-fashioned and stuffy thinking you have got to keep the leverage down. We put the leverage up and then we manage the leverage with all these wonderful new instruments.” And so those great pioneers in Amsterdam, who had worked out how to detach trading the bulb from trading the instrument, come into their own, and they have all their heirs and heiresses now, with this great barrage of instruments, and they say they are risk-reducing.

Now, if you are very clever and swift of foot, I guess they can be risk-reducing. I personally still get worried if I see an investment fund which says it is 50% net long and then I look at it and it is 550% long and it is 500% short, and they tell me, oh, it is a very low-risk fund because it has got all this wonderful insurance in place. I say, “What if…?” What if something went strange in the market so it was no longer balanced? What if you could close down one side but not the other? What if, when you wanted to net the thing off, it did not quite work? It just looks massively geared, and so you have to be careful that insurance and leverage reduction does not become leverage.

Today, if you want to be really worried, let me ask you this question: does it sound sensible that, with a world economy of a little over 60 trillion, there are derivatives outstanding to the sum of 600 trillion? Do we really need ten times the world economy to manage risk, and is that level of risk management really managing risk or is it setting up another set of problems which could prove difficult to wind down or sort out if things got rough?

Now, of course, I am not an antediluvian. I think some of these risk management products genuinely do manage risk and can be very useful. How did they start? Well, if you are a farmer producing corn, it is annoying if you only get money once a year when you manage to take the corn to market. You first of all start off with an agricultural market and the farmer takes his corn, the buyers turn up and there is an exchange – he gives the corn and the buyers give the money, and so the miller has his corn and they can go off and make the bread. That was rather inconvenient, so farmers said, “Actually, I would like some money during the course of the year, so let me sell forward some of my corn.” The miller says, “I would like to average my buying prices and it might be a good idea if I could buy some forward as well when there is not much going on in the direct core market,” and so it was in both interests. That was all absolutely fine, and the intelligent farmer and the intelligent miller found it reduced their risk, gave them better average prices, but, as you can see, they cannot both win. If the average miller was getting a cheaper price for his corn, the average farmer must have been trading badly in the futures’ market, or vice versa, but individual farmers and individual millers could benefit from this and, overall, it should not be damaging.

But if you then say that, on top of the miller/farmer transaction, you are going to have another ten men and women trading the futures just for fun, and they do not want to go anywhere near the corn – they would not be seen in a corn market and they do not want to take delivery of the corn, but they are just going to trade the corn futures. In this set-up, instead of reducing risk and reducing volatility, it could actually increase volatility, because what you then might get is a mini-bubble. So, you might get some quite powerful people coming along and buying corn futures, and they say “We think the corn price is going up,” so they buy their corn futures before they announce they think the corn price is going up, and then they tell the world “We are very clever people, we have bought corn futures, we think they are going up,” and then they find the second round of people who come in, “Yes, you are probably onto the right thing, we trust your opinion – we will buy some corn futures,” and so they get the price up a bit. And then they call in the journalists and say, “There is a big story here: we are getting horribly short of corn. Have you seen all these people buying up these corn futures? How are they going to make enough corn to meet all these unsatisfied claimants on the corn market?” Then you get a stream of articles saying that there is going to be a corn shortage, and so a the third round come in, and they start buying corn futures, and so it goes on. You have seen it. You have even participated in it, some of you, no doubt. And for an individual player, it can be sensible, benign, risk-reducing, wonderful and socially approved conduct. But if you do too much of it across the board, it can take off into bubble territory and then you get this huge increase in volatility, rather than risk-reduction, and then you can get wealth destruction as it goes through the painful cycle of unrealistic expectations. When you get to the point where people write an article about “three billion people are going to starve because of the state of the corn market”, then maybe you should start to think that it is getting a bit toppy – let us hope it is because we do not want to go into such a dreadful world. But you need to start thinking about where you are in that bubble cycle.

Now, going back to our 2006/07 problems, the crisis began with over-lending, particularly against property, in certain Western countries – the United States of America, Spain, Ireland, and the United Kingdom, to a lesser extent – and the over-lending against property had created a mini version of what happened in Japan. A lot of buildings were built in a country like Ireland or Spain that did not ultimately have people who could afford to use them or live in them. Property values were carried up to pretty high levels and, in America, where they have a more efficient market, property values started coming down as soon as they switched the credit off after 2007 and the top of the boom.

That particular boom or bubble was burst or stopped by the sudden huge lurch by the central banks and the monetary authorities from a stance of over-easy money to that of over-restrictive money, so, in a way, it was bad central banking, I think, that made that no longer feasible. You can still say the directors of mortgage banks were wrong to lend all that money on mortgage. In America, they were encouraged to by their President, who wanted to get the mortgages out there into the hands of people who could scarce afford them, for good social reasons, and the banks complied, and then suddenly, the Central Bank turned around to say that this is over the top and they were to switch off the money, and a lot of mortgages were exposed and the collapse began.

But there were other features for the collapse that were already in place, and that is that the regulators of the system had decided that the highest quality paper of all was sovereign debt. Now, they had not done their homework or read their history books because, whilst it is true that in recent years in the West, we have regarded Western sovereign debt as being of very high quality, we have accepted it almost as good as money and have allowed banks to use it as their big buttress, we surely should have remembered that certainly Latin American sovereign debt had been rather tricky and that, in living memory, we have had sovereigns like Argentina defaulting on their borrowings and creating a mini-rumpus until people get over it and then say that now Argentina has a more realistic debt level, maybe we can go back to lending to them again, and there has been quite a long period when countries like that have had to pay rather more for their money. Surely we could have seen that other parts of the public sector in advanced Western countries had sometimes managed to borrow money as if they were very good grade credit risk and then subsequently they turned out not to be, and so there had been quite a lot of losses in their particular bonds, if there was not the state guarantee people wanted.

But why did we accept that all this sovereign debt in the West was of uniformly high quality? Because, at the very same time as people were telling all these banks not just to buy British and American sovereign debt, which is still fine at current market prices, but to buy Italian and Spanish and Greek and Portuguese sovereign debt, had they not thought about the ramifications of the Euro scheme they had unleashed? Because of course, in a way, Portuguese, Spanish, Greek, Italian debt is no longer sovereign debt. Why do we tend to trust sovereign debt more than your or my debt? It is probably wrong to do so, but why do we?

Well, we do this for a couple of very good reasons, the first of which is that the sovereign has the power to demand repayment of the debts by the citizens, on power of imprisonment and the use of force, and normally, people accept the right of the sovereign to demand the tax and so they pay the tax and there is some comfort to know that you do not have to go out and persuade customers to buy more of your goods in order to repay your debt. You have got that right to demand that people pay up or go to prison, and they tend to prefer to pay up.

But there was also another feature to sovereign debt, which no longer applies in Euro-land, and that is that a sovereign has the power to print money, and so, in a way, a sovereign should not normally fail to repay you. They may debauch and devalue the money they pay back to you, but they can always, technically, pay you back in their money. They have often done this. Even very reputable sovereigns in the West have been quite happy to print and inflate away in order to make servicing their debt that much easier.

Those were the two promises that meant that people had reason to think that sovereign debt was different. The sovereign debt, so-called, of Euro-land is now, at best, half sovereign debt because they have no power to print; they cannot choose how much of their money to have, they cannot choose what interest rate to sell it at, because this is now regulated for them by a central bank. So, the position of Italy to Euro-land is rather like the position of California to the United States of America. The Californian state has certain powers. It can raise its own debt, but of course it does not have the power to print, it does not control the dollar, it does not control the structure of dollar interest rates, so it is not a full sovereign, and it does not qualify, for example, for IMF funding programmes because it is not a full sovereign and it has to go through the US federal authorities.

But our banking regulators and our bankers on the Continent of Europe did not seem to understand that there had been this very material change in the nature of the deal and that the only way now that a Euro half-sovereign has to get out of imbalances and difficulties is to play around with the debt, because they cannot play around with the money. That is why we have had the battle of Greece and why we are now in the early stages of the battle of Italy, where it is important that the authorities win that battle for the Euro if they are going to stabilise their currency and we are all going to live happily.

The Greek crisis has already reached the point where the authorities themselves think it is acceptable for a former sovereign within the Euro area to say to banks that have lent it money you are only going to get half back. Who would have thought it? If you had suggested that ten or fifteen years ago, I think you would have been regarded as some kind of nut-case – this could not possibly happen in a nice, civilised society in Western Europe. But it has happened, and it is happening. The battle over Italy is: how do you finance or re-finance the huge mountain of Italian sovereign debt, 1.9 trillion Euros by newspaper accounts (have not checked the figure); how do you refinance it when the interest rate has gone through 6% for ten-year money? I used to read that, when it went through 6%, they had lost the battle. Today, I read, when it goes through 7%, they have lost the battle. These things fluctuate. Opinions are formed and re-formed, and spindoctors spin. But, at some point, if they do not get a grip on it and find a better way of financing the Italian state, there are serious problems for Italian state debt.

So, does one bubble lead to another? Well, that one bursting leads to another would be my conclusion. And, because they decided to tackle the private sector round of the crisis by more state debt financed solutions, they have set up the second round of the crisis, the sovereign debt and the half-sovereign debt crisis. So, they made a couple of decisions in 2008, when they told us they would save the world, which set up the 2011/12 rolling crisis.

The first decision was to tell the banks they had to lend a lot more money to these sovereigns, and they changed the capital rules to give them more credit for doing so. This meant that they made sure that the banks were going to lose an absolute packet if the sovereign debt went wrong.

The second thing they did was they added, to already extremely large debts and deficits in many cases, the necessity to prop a series of banks with state money, and in many cases, the nationalisation of the banks. Ireland did not go bankrupt and go into special programme because the state was overspending; Ireland went into special programme because the ECB was no longer prepared to finance the Irish banks and the Irish banks were too big for the Irish state. The United Kingdom now has an overall debt ratio of nearly 150% of GDP, on the official consolidated figures, where you add RBS to the stock of outstanding state debt, and that is what you would have to do in private sector accounting, and that is now what this new Government has done for our public accounts, because they are now liabilities of the state, to all intents and purposes.

I was extremely sceptical about the wisdom of the state’s underwriting these extremely large global banks and all their derivatives and options and swaps. I did not think it was really any of their business, I did not think they could afford to do it, and I think it probably weakens the structure rather than strengthens it. I always favoured controlled administration. I am very pleased that the new policies for any future bubble or crisis are to adopt controlled administration, but I am not quite sure why they did not carry it backwards and see if it works in practice because they have still got plenty of these things to sort out, and I think they sooner they do it, the better. Japan did not sort her banks out quickly and savagely, and she had a long period of difficulty partly as a result. I hope we do not make the same mistake, so I hope we understand that there are banking problems still to be resolved.

So, can one bubble lead to another? Yes, it can. Can one slump lead to another? Unfortunately, yes, it can. That is my worry today; that they have spent too much on propping banks that are difficult to sustain, that they made the banks lend a lot of money back to the sovereigns, and we now have weak banks, supporting weak sovereigns, who support weak banks, and if you are in Euro-land, the sovereigns are not even sovereign.

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