Galbraith, John-Kenneth – A Short History of Financial Euphoria

Penguin Books, 1994, [Finance] Grade ★★★★★

In 1954 the Canadian-born, Keynesian celebrity economist, serial author, academic enfant terrible and producer of timeless quotations - Ken Galbraith published his now classic *The Great Crash of 1929*. It's never been out of print since. *A Short History of Financial Euphoria* is a compendious later day sequel, with a broader scope as it tries to establish a framework for how to analyze financial bubbles. It is a short, witty book with superb, sometimes cynical language. It's a pleasure to read.The general framework in itself is penned down in two initial chapters and in the concluding ending chapter, in total 30 pages. In between these chapters the author exemplifies with a chapter each on the Dutch 17th century tulip mania, the almost contemporary British South Sea bubble, the issuance of un-backed regional US fiat money at the time of the American revolution (which on the one hand paid the US military forces and won the country its independence but on the other hand lead to a long speculative period, inflation and the inevitable crash) and finally the stock market disasters of 1929 to 1932 and of October 1987.

Galbraith presents a number of factors underlying financial euphoria. First there is the combination of a person's private profit motive – a wish to get rich without effort – and group psychology that blocks all doubts. Further the "*extreme brevity of financial memory*" makes sure that we don't learn from previous bubbles (a new and risk seeking generation is always ready to enter the market) plus a naïve perceived association between wealth and intelligence. Finally, all financial bubbles include the creation of debt in some form. Financial innovation is seldom anything else than leverage. "*The world of finance hails the invention of the wheel over and over again, often in a slightly more unstable version.*" Galbraith notes that the booms and busts to a large extent seem to have endogenous origins. Much like MIT's Andrew Lo would argue today.

The anatomy of the bubble is often predictable. At first there is some profitable opportunity that captures the mind of a group. Second, the price goes up. Third, this leads to a self-feeding positive loop as the increased prices draw further investors which creates further price increases. There are two groups that participate in the bubble. On the one hand those who are believers and are convinced that a new world of immediate wealth has been born, on the other hand those who think that the price rises are unsustainable but intend to ride the wave and exit when the crash approaches. The speculative period is prolonged by the fact that those participating psychologically must justify what has made them rich and has given them a feeling of being successful and intelligent persons. Any doubters are perceived as attacking their very person. *"Speculation buys up, in a very practical way, the intelligence of those involved."*

Finally something, unimportant what, triggers a reversal. Those who thought that they could exit in time find the emergency exits overcrowded and those who believed in a new world turn into mourners. When the mass hysteria ends there will be new regulation that takes no notice of the fact that the speculative human psyche is ill suited for regulation. *"Nothing is more remarkable than this: in the aftermath of speculation, the reality will be all but ignored."* Galbraith is of the opinion that it isn't possible to avoid speculative bubbles by means of regulation. The only thing that helps is the understanding of the mass hysteria that creates them. This however, will not be the media's, the public's and the regulator's view. Since so many has participated in the mania it's much easier to search for scapegoats than to admit one's own stupidity.

It's a great shame that the orthodoxy of neoclassical economics for such a long time excluded psychology from mainstream financial thought. Galbraith, as Hyman Minsky, draws extensively on John Maynard Keynes concept of "animal spirits" when he views financial markets. This might be a short book but it's up there with Gustave LeBon's *The Crowd* when it comes to best picturing the madness of mobs.

Mats Larsson, June 19, 2013