Chapter 18
Asset Pricing Bubbles

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ABSTRACT

The chapter focuses on the significance of asset pricing bubbles in recent times. It explores the nature of this anomaly and its role in influencing financial and economic scenario of a country. It attempts to develop an understanding on identifying the pricing bubbles, how they may appear and what are the factors behind them. Further, the chapter presents a series of past encounters with this anomaly, which helps the realizing the severity of its after-effects. Their consequences are critically examined with the help of relevant literature which provides the background for probable policy implications. These implications could be categorized into public policy, monetary policy and regulatory actions. The chapter concludes on the note that a proactive approach and timely policy interventions can help curb the instances of pricing bubble episodes.

INTRODUCTION

Speculative bubbles do not end like a short story, novel, or play. There is no final denouement that brings all the strands of a narrative into an impressive final conclusion. In the real world, we never know when the story is over. Robert Shiller, (Project Syndicate Blog, 2013)

Asset pricing bubbles have generated considerable interest in recent times. These are one of the most relevant anomalies that can have extremely detrimental effect as bursting of such bubbles can lead to great turmoil in the financial markets. The severe global recession of 2008-09 is one such example. This incident has focused attention of experts on the role of asset-price bubbles in aggravating economic instability. One may think that we overcame the pricing bubble phase since the collapse of one of the biggest real estate bubble and the subsequent stock market bubble of 2007-08 and 08-09.However, murmurs of such bubbles keep reappearing. It may take the form of another housing bubble, stock market bubble, gold market

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bubble or oil price bubble, but the fact is that, this anomaly continues to sustain its significance with time. Its presence is felt only when the investors and the markets have entered it. Even at that time there were considerable proportions of people who feel that bubble does not exist and the prices of the assets concerned are justified. For instance, Fama (2010) asserts that markets are mostly efficient and anomalies like speculative bubbles do not exist. Such contradictory views of the experts add to the dilemma of this anomaly. The real trouble comes with the bursting of such bubbles that can lead to great turmoil in the financial markets. Thus, it generates considerable interest in the academicians and practitioners alike.

History reveals that speculative bubbles have shaken the financial markets since long. Its earliest evidence is given by Charles Mackay (1841). In his book Memoirs of Extraordinary Popular Delusions and the Madness of Crowds, he mentions the Dutch Tulip bubble of the 1630's, popularly known as tulip mania. Another catastrophic event in the asset bubble history had been the October 1929 stock market crash of U.S. Its most recent appearance has been in the form of the real estate bubble of 2008-09. This event made us see the potency of asset pricing bubbles in creating a nation-wide recession, which led to one of the most wide scaled economic instability that affected many countries.

Their frequent appearance poses a question: why asset pricing bubbles reappear in the market? Researchers note that bubbles exist when the price of an asset exceeds the price determined by its fundamental value by a significant amount for a prolonged period (Evanoff et al., 2012).Shiller (2005) identifies that bubbles arise as a result of the herd mentality of investors. He suggests that investors follow the crowd despite their better judgment in order to replicate the success stories of others. This contributes to the amplification of bubbles. However, it is very difficult to gauge beforehand, whether the bubble will grow until it abruptly bursts or develop and quietly go on its own without much macroeconomic impact. This uncertainty makes the bubbles even more dangerous to the financial markets. Thus, the concern warrants a need for researchers to gain maximum understanding of asset price bubbles. In this backdrop the present chapter will focus on the key issues involved in this area.

This chapter aims to develop an understanding of the meaning and relevance of asset price bubbles. It then provides a synthesis of events that illustrate the significance of this anomaly followed by critically examining its causes and consequences. Finally, it concludes the discussion by analyzing the policy implications.

DEFINING ASSET PRICE BUBBLES

In simplest terms, the bubble is a deviation of the market price of an asset from its fundamental value. This mispricing can be initiated by the occurrence of news about the fundamentals about the firm. It is further strengthened by the feedback traders who buy or sell shares in response to price movements, disregarding the actual valuation. This leads to a continuous price trend that is beyond the justification of fundamentals (Sherbina, 2013). Shiller (2005) in his book Irrational Exuberance lucidly defines speculative bubbles as "a situation in which news of price increases spurs investors' enthusiasm, which spreads by psychological contagion from person to person, in the process amplifying stories that might justify price increase". Such a psychological contagion or group mentality attracts other investors, who, despite their doubts follow the crowd, influenced partly by their envy of others successes and partly by gamblers' enthusiasm (Shiller, 2005).

IDENTIFYING THE PRICING BUBBLES

In order to respond effectively towards asset pricing bubbles, the first challenge before policy makers is to identify them. Persistent efforts have