Manias, Panics, and Crashes: A History of Financial Crises

Author: Charles P. Kindleberger

Book Summary

Charles P. Kindleberger's Manias, Panics, and Crashes: A History of Financial Crises is an engaging book on the movements of the financial markets. The book tracks the different financial crises that have plagued markets since the famous Tulipomania of 1636 to the dotcom bubble in the 21st century. Along with being an interesting read for finance and investment professionals, the book also offers some valuable lessons to the general reading populace.

Key takeaways

- Market rallies and crashes follow the typical boom-and-bust cycles.
- At the bottom of the credit cycle, investors once again start becoming enthusiastic about the markets
- During market panic situations, consumers 'freeze up' their assets and avoid spending to ensure financial safety. During a mania cycle, customers loosen their purse strings and begin spending again. Lenders start to lend, and borrowers borrow.
- Market crashes occur when, at the top of the cycle, 'insiders' make a focused move to exit the market, leading to a sudden and collective rush towards the exit. Such a movement causes mass panic, driving down prices.
- A market bubble forms due to an unjustifiable appreciation in asset prices.
- It is important to remember that bubbles will burst after a certain period of time. Indeed, it is well worth our while to remember the wise words, “If something cannot go on forever, it will stop.”

Tulipomania in the 17th century

It is interesting to note how human behaviour and market patterns usually remain unerringly similar even across centuries. In 17th century Amsterdam, specifically in 1636, the cost of tulip bulbs skyrocketed in a bizarre manner - rising hundreds and hundreds per cent. In fact, a Semper Augustus tulip bulb began to cost as much as five acres of prime land. The Viceroy bulb was being sold for an amount that was equivalent to the price fixed for two trucks of wheat, four trucks of rye, four oxen, eight picks, twelve sheep, two large barrels of wine, four tons of beer, four tons of butter, 500 kilograms of cheese, a bed, some garments, and a silver cup. What was astonishing was the fact that such payments were made for tulip bulbs which were not even existing in real life - most of the transactions were made for the procurement of contracts, or futures. The bulbs that made up these contracts were never planted, grown, or harvested. They never beautified a rich person's home with their value or exclusivity. Indeed, people were putting their hard-earned money and material assets on a piece of paper which assured them that they would receive a tulip bulb in the upcoming spring.

Analysing market cycles

Considering the Minsky model, we can see that this historic market move was created on the basis of a narrative which regarded tulip bulbs as a rare and exotic plant from the Ottoman Empire. These bulbs received the distinction of being an unparalleled status symbol. Such a narrative prompted the interest of the rich and famous, making them take an unhealthy interest in the bulb. The resulting spike in popularity led to a huge influx of money being invested in the market in the form of the future contract. People considered this investment a lucrative one, capable of offering unforeseen returns. With the booming interest, the market gained ground and people decided that no price would be too ridiculous for investment. In fact, the higher the price, the greater would be the notional value of the tulips. People believed that the price would keep rising with time, making all sorts of investments in the expectation of great returns. A classic feedback loop was created, with price appreciation breeding a further rise in prices. The bubble expanded until there was no more money to be invested, resulting in a subsequent crash which negated the value of both the bulbs as well as the future contracts.

Historical financial manias and patterns

When you consider a well-functioning market, with its inherent cycles of mania, panic and crashes, you will notice that there are some typical factors that usually lead to the formulation of a mania and, sometime later, an inevitable crash. In such a scenario, the foremost factors have been a significant rise in foreign investment flows along with an increase in credit. Such rises have resulted in an increase in stock and real estate prices, leading to further hikes in cross-border investment inflows and credit. Consequently, an incremental rise is seen in the asset prices, leading to a positive feedback cycle boosted by behavioural

phenomena. Asset bubbles, at least most asset bubbles, are a monetary phenomenon and result from the rapid growth in the supply of credit. Market euphoria or mania can be triggered by factors including a technological development, a radical political initiative or a financial invention which manages to take the world by storm in such a manner that investors begin to believe in a financial resurrection.

Expansion of the credit line

With the market undergoing a delirious euphoria, lenders and creditors tune in on the opportunities of profit presented by such a scenario. They gain the courage required to issue loans to parties composed of private and corporate borrowers. Companies take loans to bolster their operations while also investing in financial markets or other businesses to boost their market returns. Individuals, buoyed by the market sentiment, take loans to buy cars, securities, commodities, and real estate. The plot thickens with businesses extending credit lines to expand production facilities with the intention of accommodating the increased requirement for goods and services. Additionally, banks and financial institutions also jump on to the bandwagon and look to capitalize on this booming optimism by lending money at high interest rates. The entire cycle revolves around a significant expansion of the credit line.

Speculation in the market

Once the credit lines are expanded and businesses and banks are minting money from the ongoing boom, the economy moves into the third phase of the cycle: speculation. The general public now starts to notice the rise in financial markets and starts investing to earn handsome returns and capitalise on the development. This interest, and consequent buying, creates a feedback loop in which speculators make gains by ploughing more money into the markets. The resulting rise in prices ensures that more individuals are prompted to invest even more money into the system, leading to a major hike in asset prices. Even as participants buy more assets, they make the purchase with the belief that they will be able to sell the same to future investors, at a comparatively higher price. Such expectations, and the continued buying sentiment leads to a further build-up of the bubble.

Formation of the bubble

The most surprising feature of a financial bubble is the inability of those trapped inside it to notice and understand the seriousness of their situation. Market players know, in principle, that market bubbles exist, and they realise that financial crashes are the inevitable outcome of such bubbles bursting. However, when a new bubble begins to take shape, participants invariably believe that this time will be different from the others, and continue to invest.

Evolution of market panics

Though market manias lead to a dizzying rise in prices, across asset classes, the party stops when creditors start getting worried about the ability of debtors to pay back the loans that they have taken to invest in the rising market. Such concerns indicate the beginning of panic mode, which prompts creditors to put a stop to issuing new loans. In such a situation, the debtors who were relying on additional loans to cover their interest payments, face bankruptcies as the cash flow dries up and repayments begin looming in front of them.

Turn of the tide

At the peak of the market cycle, there are always some 'insiders', or market experts who understand the important difference between price and value. These people usually decide to close their positions at the right time and exit the market with substantial returns. The emergence of liquidity issues and bankruptcies are generally the first indications that markets are at a peak. These issues usually come to the fore when lenders, including banks and other parties, refuse to lend to businesses and individuals the capital that they require to stay afloat and maintain their positions in the market. With the turn of the tide, markets experience a sudden and collective move towards the exit. Each person or entity holding positions in the market now desires to sell and exit. This leads to mass panic and a further freefall in prices.

Ensuing crashes and the aftermath

A continued fueling of the bubble, without consideration of its after-effects, is usually the underlying cause for market crashes. Studies show that most upswings last up to 7-8 years while the consequent recession takes less than a year or two to wipe out accumulated wealth. Even as the cycle ends with enormous loss of capital and economic setbacks, the stunning fall in prices prompts courageous investors to begin building positions again, kick-starting the entire process all over.

Fraudulent behaviour

The fraudulent behaviour depicted by individuals like Charles Ponzi and Bernie Madoff is a typical theme that follows a market mania. The critical thinking skill of evaluation is applied to study and decipher the strange mindset of fraudulent individuals who offer arguments to support their actions. Even as we consider the reason behind such actions and the resultant market crashes, one timeless lesson comes forth – it is impossible to bring about major changes in human behaviour. In fact, the wise words of George Santayanas' can be quoted here, "Those who do not remember the past are condemned to repeat it."

Advice to investors and policymakers

While there are several arguments in favour of both the top-down and the bottom-up approaches to investing, value investors usually opt for the bottom-up approach where they consider company fundamentals. Other types of market participants also eye factors like the business cycle and various macro factors. In such investment scenarios, top-down investors usually risk entering the trap of trying to predict the unpredictable. With investment being a highly stress-inducing game with multiple variables, it is important for all investors to analyse financial history and learn from past events as history is known to repeat itself.

While policies may change, and there may be subtle or marked variations in economic circumstances, human psychology and the oscillation between fear and greed are likely to remain constants in market culture. People have a tendency to forget past mistakes and become complacent and open to risky ventures after a period of general well-being. This is invariably seen in market cycles too. However, both investors and policymakers need to remember that complacency can be a self-denying prophecy leading to a panic-inducing market crash.

Kindleberger's book highlights some important aspects of market cycles including the tendency of people to forget past cycles when markets are rising. One of the biggest factors that contribute to creating market cycles is investor behaviour and the inability to consistently make rational decisions. A simple solution can be long-term investments in mutual funds through the Systematic Investment Plan (SIP) route. Mutual funds are investment vehicles that invest in a wide array of assets including equity, debt, and gold. Further, they are professionally managed and investment decisions are usually based on pre-determined criteria and strategies. On the other hand, SIPs are a way to invest in mutual funds. They allow you to invest a fixed amount of money into the mutual fund scheme of your choice, and at time periods that suit you best – this could be fortnightly, monthly, or even quarterly. By choosing such a way to invest in mutual funds, you can easily reduce the impact of behavioural biases in your investment decisions and stay invested for the long-term through multiple cycles of boom and bust.

An investor education initiative by Edelweiss Mutual Fund
All Mutual Fund Investors have to go through a onetime KYC process. Investor should deal only with Registered Mutual Fund (RMF). For more info on KYC, RMF and procedure to lodge/redress any complaints – please visit on
https://www.edelweissmf.com/kyc-norms

MUTUAL FUND INVESTMENTS ARE SUBJECT TO MARKET RISKS, READ ALL SCHEME RELATED DOCUMENTS CAREFULLY.