

C H A P T E R 1

THE SPECULATIVE EPISODE

Anyone taken as an individual is tolerably sensible and reasonable—as a member of a crowd, he at once becomes a blockhead.

—FRIEDRICH VON SCHILLER,
AS QUOTED BY BERNARD BARUCH

That the free-enterprise economy is given to recurrent episodes of speculation will be agreed. These—great events and small, involving bank notes, securities, real estate, art, and other assets or objects—are, over the years and centuries, part of history. What have not been sufficiently analyzed are the features common to these episodes, the things that signal their certain return and have thus

the considerable practical value of aiding understanding and prediction. Regulation and more orthodox economic knowledge are not what protect the individual and the financial institution when euphoria returns, leading on as it does to wonder at the increase in values and wealth, to the rush to participate that drives up prices, and to the eventual crash and its sullen and painful aftermath. There is protection only in a clear perception of the characteristics common to these flights into what must conservatively be described as mass insanity. Only then is the investor warned and saved.

There are, however, few matters on which such a warning is less welcomed. In the short run, it will be said to be an attack, motivated by either deficient understanding or uncontrolled envy, on the wonderful process of enrichment. More durably, it will be thought to demonstrate a lack of faith in the inherent wisdom of the market itself.

The more obvious features of the speculative episode are manifestly clear to anyone open to understanding. Some artifact or some development, seemingly new and desirable—tulips in Holland, gold in Louisiana, real estate in Florida, the superb economic designs

of Ronald Reagan—captures the financial mind or perhaps, more accurately, what so passes. The price of the object of speculation goes up. Securities, land, objets d'art, and other property, when bought today, are worth more tomorrow. This increase and the prospect attract new buyers; the new buyers assure a further increase. Yet more are attracted; yet more buy; the increase continues. The speculation building on itself provides its own momentum.

This process, once it is recognized, is clearly evident, and especially so after the fact. So also, if more subjectively, are the basic attitudes of the participants. These take two forms. There are those who are persuaded that some new price-enhancing circumstance is in control, and they expect the market to stay up and go up, perhaps indefinitely. It is adjusting to a new situation, a new world of greatly, even infinitely increasing returns and resulting values. Then there are those, superficially more astute and generally fewer in number, who perceive or believe themselves to perceive the speculative mood of the moment. They are in to ride the upward wave; their particular genius, they are convinced, will allow them to get out before the speculation

runs its course. They will get the maximum reward from the increase as it continues; they will be out before the eventual fall.

For built into this situation is the eventual and inevitable fall. Built in also is the circumstance that it cannot come gently or gradually. When it comes, it bears the grim face of disaster. That is because both of the groups of participants in the speculative situation are programmed for sudden efforts at escape. Something, it matters little what—although it will always be much debated—triggers the ultimate reversal. Those who had been riding the upward wave decide now is the time to get out. Those who thought the increase would be forever find their illusion destroyed abruptly, and they, also, respond to the newly revealed reality by selling or trying to sell. Thus the collapse. And thus the rule, supported by the experience of centuries: the speculative episode always ends not with a whimper but with a bang. There will be occasion to see the operation of this rule frequently repeated.

So much, as I've said, is clear. Less understood is the mass psychology of the speculative mood. When it is fully comprehended, it allows those so favored to save themselves from disaster. Given the pressure of this

crowd psychology, however, the saved will be the exception to a very broad and binding rule. They will be required to resist two compelling forces: one, the powerful personal interest that develops in the euphoric belief, and the other, the pressure of public and seemingly superior financial opinion that is brought to bear on behalf of such belief. Both stand as proof of Schiller's dictum that the crowd converts the individual from reasonably good sense to the stupidity against which, as he also said, "the very Gods Themselves contend in vain."

Although only a few observers have noted the vested interest in error that accompanies speculative euphoria, it is, nonetheless, an extremely plausible phenomenon. Those involved with the speculation are experiencing an increase in wealth—getting rich or being further enriched. No one wishes to believe that this is fortuitous or undeserved; all wish to think that it is the result of their own superior insight or intuition. The very increase in values thus captures the thoughts and minds of those being rewarded. Speculation buys up, in a very practical way, the intelligence of those involved.

This is particularly true of the first group

noted above—those who are convinced that values are going up permanently and indefinitely. But the errors of vanity of those who think they will beat the speculative game are also thus reinforced. As long as they are in, they have a strong pecuniary commitment to belief in the unique personal intelligence that tells them there will be yet more. In the last century, one of the most astute observers of



Fellow bankers and the investment houses in 1929 assailed Paul M. Warburg, a banker and founder of the Federal Reserve System, for his warnings of a crash.

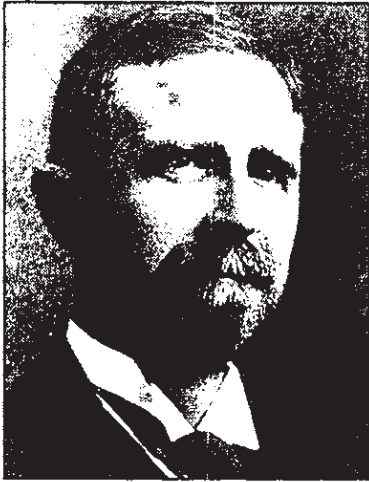
the euphoric episodes common to those years was Walter Bagehot, financial writer and early editor of *The Economist*. To him we are indebted for the observation that “all people are most credulous when they are most happy.”

Strongly reinforcing the vested interest in euphoria is the condemnation that the reputable public and financial opinion directs at those who express doubt or dissent. It is said that they are unable, because of defective imagination or other mental inadequacy, to grasp the new and rewarding circumstances that sustain and secure the increase in values. Or their motivation is deeply

suspect. In the winter of 1929, Paul M. Warburg, the most respected banker of his time and one of the founding parents of the Federal Reserve System, spoke critically of the then-current orgy of “unrestrained speculation” and said that if it continued, there would ultimately be a disastrous collapse, and the country would face a serious depression. The reaction to his statement was bitter, even vicious. He was held to be obsolete in his views; he was “sandbagging American prosperity”; quite possibly, he was himself short in the market. There was more than a shadow of anti-Semitism in this response.

Later, in September of that year, Roger Babson, a considerable figure of the time who was diversely interested in statistics, market forecasting, economics, theology, and the law of gravity, specifically foresaw a crash and said, “it may be terrific.” There would be a 60- to 80-point drop in the Dow, and, in consequence, “factories will shut down...men will be thrown out of work...the vicious circle will get in full swing and the result will be a serious business depression.”

Babson’s forecast caused a sharp break in the market, and the reaction to it was even more furious than that to Warburg’s. *Barron’s*



Economist Roger Babson's forecast of the crash of 1929 brought him grave rebuke from the great financial houses of the time.

said he should not be taken seriously by anyone acquainted with the “notorious inaccuracy” of his past statements. The great New York Stock Exchange house of Hornblower and Weeks told its customers, in a remarkably resonant sentence, that “we would not be stampeded into selling stocks because of a gratuitous forecast of a bad break in the market by a well-known statistician.” Even Professor Irving Fisher of Yale University, a pioneer in the construction of index numbers, and otherwise the most innovative economist of his day, spoke out sharply against Babson. It was a lesson to all to keep quiet and give tacit support to those indulging their euphoric vision.

Without, I hope, risking too grave a charge of self-gratification, I might here cite personal experience. In the late winter of 1955, J. William Fulbright, then the chairman of the Senate Banking and Currency Committee, called hearings to consider a modest speculative buildup in the securities market. Along with Bernard Baruch, the current head of the New York Stock Exchange, and other author-

ities real or alleged, I was invited to testify. I refrained from predicting a crash, contented myself with reminding the committee at some length as to what had happened a quarter of a century earlier, and urged a substantial protective increase in margin requirements—down payments on the purchases of stocks. While I was testifying, the market took a considerable tumble.

The reaction in the next days was severe. The postman each morning staggered in with a load of letters condemning my comments, the most extreme threatening what the CIA was later to call executive action, the mildest saying that prayers were being offered for my richly deserved demise. A few days later I broke my leg in a skiing accident, and newsmen, seeing me in a cast, reported the fact. Letters now came in from speculators saying their prayers had been answered. In a small way I had done something for religion. I posted the most compelling of the communications in a seminar room at Harvard as an instruction to the young. Presently the market recovered, and my mail returned to normal.

On a more immediately relevant occasion, in the autumn of 1986, my attention became focused on the speculative buildup then tak-

ing place in the stock market, the casino manifestations in program and index trading, and the related enthusiasms emanating from corporate raiding, leveraged buyouts, and the mergers-and-acquisitions mania. *The New York Times* asked me to write an article on the subject; I more than willingly complied.

Sadly, when my treatise was completed, it was thought by the *Times* editors to be too alarming. I had made clear that the markets were in one of their classically euphoric moods and said that a crash was inevitable, while thoughtfully avoiding any prediction as to precisely when. In early 1987, the *Atlantic* published with pleasure what the *Times* had declined. (The *Times* later relented and arranged with the *Atlantic* editors for publication of an interview that covered much of the same ground.) However, until the crash of October 19 of that year, the response to the piece was both sparse and unfavorable. "Galbraith doesn't like to see people making money" was one of the more corroding observations. After October 19, however, almost everyone I met told me that he had read and admired the article; on the day of the crash itself, some 40 journalists and television commentators from Tokyo, across the United

States, and on to Paris and Milan called me for comment. Clearly, given the nature of the euphoric mood and the vested interest therein, the critic must wait until after the crash for any approval, not to say applause.

To summarize: The euphoric episode is protected and sustained by the will of those who are involved, in order to justify the circumstances that are making them rich. And it is equally protected by the will to ignore, exorcise, or condemn those who express doubts.

Before going on to look at the great speculations of the past, I would like further to identify the forces that initiate, sustain, and otherwise characterize the speculative episode and which, when they recur, always evoke surprise, wonder, and enthusiasm anew. All this we will then see in nearly invariant form occurring again and again in the history I here record.