Asset bubble

Business

An asset bubble can most easily be described as a period in financial markets when asset prices are inflated or unrealistically increased. The prices of assets during such a period vary considerably from the asset's intrinsic value . This asset price inflation can be short lasting or may persist for long periods of time, but eventually the prices deflate rapidly (a phenomena called bubble bursting) (Simkovic, 2009). This causes the price of the some commodities to normalize or often fall below their real values. Over the years, there have been various phenomena like this.

An asset Bubble is a complex phenomenon and a clear analysis of the actual causes are hard. This paper will critically evaluate the causes and the impact of the asset bubble of 2008. Occurrences prior to asset bubble Edward & Saiz (2008) indicates that there are factors, found in a financial system, which are enormously associated with an asset bubble. The factors are believed to be the main cause of the price inflation resulting to the bubble. They include the following: Excess liquidity Liquidity means the amount of cash circulating in a financial system.

When people have easy access to cash, they become willing to spend even when what they purchase is overrated (Leibold, 2004). Conducive bank policies Banks are used as regulatory mechanisms by the Central Bank to regulate inflation. If banks give loans at exceptionally low rates, more people are willing to take loans. These loans lead to the excessive liquidity as explained above. Unrealistic speculation This means projection of the future prices of specific assets based on the historical trends related to trade in those assets also the current consumer expectations.

For instance, prices of houses maybe exaggerated, due to speculative behaviour of asset management institutions. This is further worsened by the willingness of the buyers to spend hoping to sell again when prices get even higher (Edward & Saiz, 2008). Insurance policies If insurable institutions, such as the mortgage business, control assets then these companies can easily forego their moral obligation of protecting the common buyer in the bubble burst and they should instead rely on the fact that, they (the mortgage company) are insured. Thus, they take advantage of a bubble to rake in enormous profits in exaggerated sales just before a bubble bursts, and later lay claims on their insurers when the market collapses. This leads to large burdens on the insurance companies and has led to the collapse of global insurance giants (Leibold, 2004). Inefficient market regulation Even though this is in itself not a cause, it encourages the asset inflation.

The central bank or the Federal Reserve is mandated with control of financial systems, usually through sound monetary policy including cost-benefit analysis and inflation check. When a central bank is unsure whether to allow uncommon activity in a particular sector (due to fear the it may not be an asset bubble), or to stop the activity (due to the fear that the losses in the economy in the event that the activity is not a bubble will be great), an inflation can quickly build up and not be realized until it is too late. The most commonly cited examples are the British South Sea Bubble of 1711-1720, the Dutch Tulip Mania of 1637, the Japanese Asset price Bubble of 1980s, the Dot Com bubble of 1995-2000 and the recent Global Asset bubble of 2008. This paper will discuss the Asset Bubble phenomenon, with a focus on the 2008 asset bubble. It will critically look at the causes of an asset bubble, the

impacts it had in the various economic or financial systems, and the possible ways of preventing reoccurrence of the same (Edward & Saiz, 2008). The 2008 Asset Bubble The Asset Bubble of 2008 was a key occurrence that precluded the famous Global Crisis or Global Economic Recession of 2008.

Some of its results were collapse of large financial institutions, national governments interventions into the financial systems by bailing out banks and insurances companies, and a significant downturn of stock markets all over the world. The housing markets were also affected, leading to evictions, closures, unemployment, and substantial declines in consumer wealth worth trillions of dollars. A significant area of the 2008 asset bubble was the United States housing bubble that collapsed in 2006-2007 (Barrett, 2009). In the period between year 2000-2004, housing prices in the U. S.

plummeted as more and more people pulled out low interest loans to invest in mortgages and houses. As of late 2005, the housing market had reached its peak and analysts already had predicted its downfall. When finally the values of homes began to decline, millions of investors were rendered incapable of servicing their loans as their equity in the housing investment declined and most had mortgages higher than the values of their homes. Though the crisis is believed to have begun in the U. S.

, as a complex relation between asset valuation and liquidity issues, its effects were pronounced throughout the global market. The crisis was characterized by low purchasing power of consumers, loss of investments and severe decline in value of the stock markets (Gullapalli, 2010). Causes of the Asset Bubble Deregulation The Glass-Steagall Act, which regulates the

financial markets, has historically separated investment banks and commercial banks, and set limits on banks’ lending rates and loans. However, several de-regulation incentives were allowed in 1980 that permitted similar banks to link and set their own interest rates. In addition, the Garn-st Germain Depository Institutions Act 1982 allowed mortgage companies to adjust their mortgage rates.

Further, in 1999, act called the Gramm-Leach-Bliley Act let investment and commercial banks to merge (Robinson, 2008). The combined effects of these three acts were to create an environment where regulatory measures were restricted and where no one would take responsibility for the crisis. Low mortgage interest rates The Federal Reserve lowered interest rates for mortgage products after the Dot Com bubble, allowing banks to offer low rate loans for mortgage products. By 2006, the rates increased to 5. 25% lowering the demand for loans and, at the same time, increasing the variable interest monthly repayments. Mortgaging companies put the mortgage schemes together nd sell them to the Wall Street investors, thus looking for higher returns, but this was high risk lending.

Credit rating agencies failed to offer correct advice to lending banks and financial institutions, allowing the institutions to take risks that were irreversible in case of default or market collapse (Simkovic, 2009). Subprime Lending Subprime lending essentially means lending to persons or parties without clear repayment ability. Typically, these loans are given at a higher rate than the prime rates in order to compensate for the risk (Barrett, 2009). During the bubble, loans were given at low interest, translating to a large number of loans taken at a unit time. Further, the cost of homes was rising

rapidly, thus the lending institutions could easily resell mortgaged homes to new parties if the original owners were unable to service the mortgages. This was seen as an advantage for the risky lending by the lending banks and mortgage companies.

In 2006, subprime mortgages accounted for 20% of total mortgages valued at $600 billion (Robinson, 2008). Figure 1 U. S. Subprime Lending Expanded Significantly 2004-2006 Housing tax policy The Tax Reform Act, 1986 and the Taxpayer relief Act, 1997 allowed exclusion on capital gains on the sale of homes by $500, 000 for a couple and $250, 000 for a single seller. This encouraged people to invest in high priced mortgaged homes instead of investing in stocks, bonds and other assets. Therefore, when the prices of homes began to fall, they lacked any fallback plans and investment was lost (Simkovic, 2009).

Panic buying During the period in which market prices for homes were rising, mortgage companies as well as other lending institutions, the media, and online social sites exaggerated the urgency of home ownership. There were assertions that those who failed to buy homes then, would never afford to buy them afterwards. This motion was encouraged by the then rapid rise in home costs, and prompted large numbers of homebuyers to take mortgages and hurry to purchase homes even without a clear projection of how to repay (Branch, 2006). Mortgage fraud There were cases where mortgage companies engaged in professional malpractice in the way of overlooking necessary documents and other requirements. Cases of falsified information, lack of documentation and even information tempering were found.

In the resulting period after the bubble burst, tens of mortgage companies were investigated, leading to company closures and prosecutions. Compromised realtor policy Instead of negotiating in favour of the customer, real estate agents (who are paid based on commission of the sales made) mislead the homebuyers into buying the overpriced assets in order to increase their commissions. This led to massive investment in property whose real value was less than the purchase value (Lahart, 2007). Inability to pay the monthly instalmentsSince the price of an inflated asset is high, it means the monthly mortgage payment is also high (Branch, 2006). As the owner rents the home, they will require paying the mortgage from the rent collected, after catering for taxes and home maintenance. During the housing bubble, most renting homeowners found that the money collected in rent was less than money owed as monthly mortgage payment, meaning they had to settle the difference from other sources (Gyourko, 2008).

Effects of increasing foreclosures cases The number of people who were unable to service their mortgages increased, thus forcing banks to repossess their homes for resell purposes. This factor put pressure on demand-supply ratios in certain areas; as more homes were abandoned and waiting to be resold, their market prices reduced as banks tried to avoid maintenance related costs of re-possessed homes (Robinson, 2008). Predatory lending Predatory lending is the practice of lenders enticing borrowers to get into unsecure loans for inappropriate purposes and has been seen as a contributing factor to the financial crisis. The most common method used, was the advertising of loans at low interest and later charging borrowers higher (Shleifer, 2000). The consumers would be put into an Adjustable Rate

Mortgage (ARMs) where the interests charged would be higher than the interests paid.

This is contrarily to the advertisement stating that the interest charged would be 1% or 1. 5%, resulting to negative amortization, which borrowers might not realize until after completion of the transaction (Kaufman, 2001). Over-leveraging In the period before the crisis, lenders and other financial institutions became highly leveraged increasing their risky investments and reducing their abilities to deal with potential losses. Financial instruments such as off-balance sheet securities and financial derivatives and Collateralized Debt Obligations (CDOs) were used to make it hard for creditors and regulators to oversee and reduce the levels of financial risks (Shleifer, 2000). This contributed to the need for government bailouts, as the institutions were not properly guarded against bankruptcy.

As the housing bubble expanded, the U. S. households and financial institutions became increasingly indebted as a result of over-leverage. Their vulnerability to the collapse of the housing bubble was increased (Gordon, 2008). Impact of the 2008 Housing Bubble Burst Impact on financial markets U.

S. Stock market The U. S. stock market, which was at its peak in October 2007, entered a sustained decline that increased in October 2008. The stock market has recovered much of the effect markedly in the first half of 2011 (Lewis, 2008). Financial institutions The International Monetary Fund (IMF) has estimated the losses of large American and European banks at more

than $1 trillion in toxic assets and substandard loans from January 2007 to September 2009.

These banks might still face further losses and the IMF estimates that, US banks are 60% through their losses and those in the Europe zone only 40% (Garber, 2001). At the beginning of the crisis, only institutions directly involved in house construction and mortgage lending were affected, as they were no longer access financing through credit markets. Many of these mortgage lenders went bankrupt between 2007 and 2008 (Gordoon, 2008). The peak of this financial institutions crisis came in September and October 2008, when several leading institutions failed and were taken over by governments or were acquired under difficult financial situations. Credit markets and Shadow banking system The credit crisis is also explained by economists through the entry of the shadow banking system to the financial system (Hommes, 2005).

The shadow banking system had become immensely popular and was nearly as valuable as traditional commercial banking sector. Investment banks and other institutions in the shadow banking system lacked the capacity to provide funds to institutions and mortgage lenders. Therefore, they had to obtain investor funds in exchange for asset-backed commercial paper or mortgage backed securities. The collapse of the shadow banking was responsible for the reduction in funds available for borrowing since traditional banks have raised their lending standards (Noussair, 2001). Impact on wealth and investment There exists a direct relationship between declines in wealth and declines in investment and consumption, which together with government spending represent the position of the economy.

Americans lost an estimated of more than a quarter of their total net worth between June 2007 and November 2008 (Cassidy, 2009). The decline in the average U. S. housing prices was over 20%; the total home ownership, which had been estimated at $13 trillion in 2006, dropped to $8 trillion by mid-2008, and the decline continued as the year progressed. The second largest American house hold asset, total retirement assets, dropped by 22%.

Savings and investment assets lost $1. 2 trillion while pension assets lost $1. 3 trillion (Noussair, 2001). The total losses are large and the household wealth is down by $14 trillion. In the years preceding the crisis, US home owners had extracted significant equity from their homes, which they could no longer do once the housing boom collapsed.

As the housing bubble grew, the amount of free cash used by consumers from home equity extraction also increased. Home mortgage debt in the US relative to GDP rose from 46% during the 1990s to 73% during 2008 (Shleifer, 2000). Effects of the crisis to the U. S. Economy The output of goods and services produced in the U.

S. reduced at an annual rate of 6% between 2008 and 2009. Unemployment remains high, even as the economy struggles to create jobs, with unemployment rates increasing to 10. 1 % by October 2009 (Noussair, 2001). This is almost twice the pre-crisis unemployment rates. The average working hours reduced to 33 in a week; the lowest level since data collection was started by the government in 1964.

Support from the economic stimulus and the change in the inventory cycle is reducing leading to slow growth (Lewis, 2008). Wealth distribution Though

there were losses, the poor lost relatively more than the rich in the population, widening the wealth gap between the economic class at the top of the demographic pyramid and those beneath them (Topol, 2001). The top 1% who owned 34. 1% of the nation’s wealth increased their share of wealth to over 37. 1% by 2009. The wealth of typical American families suffered a decline with the total wealth of 63% of all Americans being affected.

The GDP growth was extremely weak in 2009 for the Euro zone and even negative for the UK, Ireland and Spain. A worldwide recession of -0. 3% was predicted for 2009 by the IMF averaged over the developed economies. Consequently, several countries were forced to launch large bailout packages for their economies from November 2008. Global effects Fears of a global economic collapse have been prompted by the continuing development of the crisis.

The world has started to take the necessary actions to fix the crisis: cutting interest rates; capital input by governments; systemic injection (Garber, 2001). Major Banks have collapsed around the world with Iceland’s banking collapse being the largest suffered by any country in economic history. The U. S., Euro zone and the UK experienced negative growth in 2009 and remarkably little growth in 2011, though not as terrible as that during the Great Depression.

Reports show that consumption in the U. S. accounted for more than a third of growth in global consumption in the duration between 2000 and 2007. The economy has been consuming too much and borrowing too much leading to

the rest of the world depending on consumer as a source of global demand. With increased savings rate of the consumers and a recession in the U. S.

, growth elsewhere has been declining dramatically (Topol, 2001). Possible preventive measures against Asset Bubbles Regional market systems control Most countries agree that a global response is the most suitable method of preventing bubbles. The U. K. asserts that there need to be internationally governed regulatory measures in controlling markets, including systems for early warning, cross-border supervisions and dedicated collaboration across countries. The United Nations has recommended the formation of a Global council on economic coordination (Noussair, 2001).

Fiscal austerity policy Countries that undergoing hard times are following this prescription, though it may take a long time for them to grow out of debt. Many countries have been weak in productivity and growth trends over the past decade, and investing in their sovereign bonds will take a lot of will (Hunter, 2005). Reforming the International financial system Fundamental reforms for financial systems internationally have been called for. These include reforms in international banking and finance and international institutions like the World Bank and the IMF (Briggo & Torresetti, 2010). The key changes will involve their management.

The financial crisis of 2008 was a clear result of what uncontrolled asset market systems can become (Briggo & Torresetti, 2010). It is evident that the economic well-being of one country is affected profoundly by the stability of another country. It is a collective duty of all countries that are part of the global economy to monitor their own economic policies as well as keep an

eye on all other countries (Lewis, 2008). Global commissions for market regulations need to be formed and to work towards a sustained global economy. This way, asset bubbles can be prevented entirely or detected before they mature or burst and it is too late.