Economic bubble

Economics

Economic bubble is an important concept within any economic framework. Basically, the importance of this aspect lies in the effect it endows in the broader economic functionality. To understand and create a detailed framework for this paper, a theoretical establishment of the phenomenon is developed. Either, the paper does not achieve a rational response when the causes of the crisis in not cohesively described. Seldom therefore, this is achieved by the intrinsic evaluations into these causes based on the framework of the stock and asset market within the economy.

The paper concludes by establishing the outlay of the effects that are endowed by this problem Economic bubble Economic bubble is the term used in the financial market to refer to a situation where the market is characterized by a temporary excessive buying and shoot up in prices which does not reflect the fundamental value. It has been referred to by many economists in different terms that include the speculative bubble, market bubble, financial bubble, price bubble and speculative mania.

Economic bubble is fundamentally believed to be caused by mob influence where the investors rush to partake their actions when they notice or predict an upward trend of prices on specific stock (Melden, 2007, 11). The triggers of economic bubbles still remain an issue of debate to many financial experts since there are many theories behind it. Others believe that their is nothing like economic bubble that exists since they have strong believe that prices of any stock frequently have a big variance from their fundamental value.

From the recent experiences in the market, it has been evident that economic bubble can occur in the absence of bound rationality, uncertainty and speculation. Of late, a school of thought has advanced an argument that proposes that market bubble can occurs as result the emerging social norms as well as price coordination. Generally, within the real life market , it is very hard to follow the fundamental value of stock.

The process of predicting a bubble is based on studying the trends of stock prices in the past to find out a spontaneous fall in price. The sudden drop in price is referred to as crash or bubble burst. The stage of the bubble development and the bursting constitutes the cumulative causation or the positive feedback. On the other hand, the equilibrium price is determined by the negative feed back when all factors are held constant.

In an economic bubble, the supply and demand principle which is the determining factor for prices ceases or becomes ineffective due to rapid changing of prices (Arestis, Michelle, 2001, 15). Despite the perpetual disagreements and debates about the real causes of economic bubble, there are various causes that have been proposed as the likely triggers of this effect. One of these triggers that have been suggested so far is explained by the greater fool theory.

Though this theory has not been proved through experimental studies. The theory asserts that the economic bubble is propelled by the habit of hopeful stock market investors regarded as the falls, who usually buy stock whose value is inflated with prospects of selling the same stock to other optimistic investors, regarded as the greater fools. These greater fools buy the stocks at higher price with an expectation of selling them to others also at a profit.

The building up of the bubble continues out the chain provided that there are such (greater fools) who can purchase the stock with inflated price (Brown, 1999, 24). The other factor that has been suggested by the financial experts in attempt to explain the causes of economic bubble is the greed among the stock market participants. In this case, the financial experts say that the development of economic bubble is nurtured by the ever common greed under the pretext of over ambitiousness which is popular among many market players.

Here, the market participants forecast the value of the stocks at unrealistic future returns prompting to purchase the stocks with the sole target of tapping those hypothesized future stock prices which promise good returns. The excessive buying of such stock reaches a point where it gives no returns to the buyers and this makes them to get dissatisfied hence they start claiming for higher returns. Herd behavior has also been suggested to play a key role in economic bubble development.

This suggestion is pegged on the idea that market participants tend to follow and be guided by the market patterns during the buying and selling of stock. At many times, this habit is encouraged by the stock market analysts since they are ever following the stock market trends with which they are able to detect their stability and base their decision on them when buying the assets. This results to a sudden change of both the demand and price of the assets with which higher returns are expected in the future (Case, Shiller, 2003, 17).

Financial experts have not left out the aspect of financial liquidity in the outlay of the causes suggested as responsible for economic bubble. Increased availability and accessibility tomoneyin the financial systems makes money to be in excess. The excessive money leads to increased demand for goods and services and this situation in turn results to sudden upsurge in prices. When this occurs, the investors rushes to buy assets with the expectation of continued increase in the price for the goods and services.

It is known that liquidity increases when the lending institutions engages in strategies of widening their scope of lending, a condition that results to lowering of interest rates and consequently increasing the money in circulation and disposable income. During such times, the market players often reduce their capital saving in bank accounts and they alternatively increase borrowing from the banks and put the excess capital in the hyper inflated assets that commonly include real estates and equities.

The hyper inflation causes increased demand for assets that are of both high and low quality thus fooling the investors to forget the intrinsic value of the assets. The bubble may crash when the central bank comes up with a strategy to absorb the excess money back to the treasury. Once this happens, the interest rates in the situation is reversed and this frequently leads to the bubble crash (Brown, 1999, 18).

In addition, other people suggest that economic bubble may result from the breakdown in thecommunicationof essential economic determinants by the stock market leaders to all market players. Also, it is attributed to poor accounting systems that results from overvaluation of assets than their real value. Economic bubbles have many impacts to the economy which are fundamentally negative. In simple terms, economic bubble leads to misappropriation and investment of resources to areas where they cannot bear maximum economic returns.

When the bubble crashes, it results to the destruction of vast amounts of wealth that leads to cyclic economicdepressionif the right strategies are not put in place (Melden, 2007, 26). The other adverse impact of economic bubble is that it dupes the market participants by making them to feel as having a lot of wealth. This mentality drives them to the habit of spending excessively on unnecessary on expensive goods and services.

When the bubble crashes, the investors are caught by surprise, since their assets lose value drastically in which case they are overwhelmed by a feeling of poorness. At this state, the investors affected cut down their spending trends thus affecting the growth of the economy and even the business people whom the investors used to get goods and services from the time they used to presume themselves rich (Case, Shiller, 2003, 32).

There are many examples of economic bubble that have occurred world wide living the economies with many bruises. Just to mention but a few in the recent past they include the Romanian and Spanish property bubble both of 2008, the United States and British property bubbles of 2007 and 2006 respectively. Elsewhere, the Dot com bubble of between 1995 and 2001 is a significant example that crippled the Dot com group of companies in the United States of America.

In conclusion therefore, it is worth to say that economic bubble is one of the greatest threats to the global economy of any country and therefore central banks should always be on the highest alert to prevent any trend in the financial system that can lead to this condition.

Work Cited

Arestis Philip & Michelle Baddaley. What Global Economic Crisis? New York, Palgrave, 2001, pp. 15 Browne Lynn. U. S. Economic Performance: Good Fortune, Bubble, or New Era. New England Economic Review, 1999, pp. 18, 24 Case Karl & Shiller Robert. Is There a Bubble in the Housing Market? Brookings Papers on Economic Activity, 2003, pp. 17, 32 Medlen Craig. The Bubble Machine: Relative Capital Valuation, Distributive Shares and Capital Gains. Journal of Economic Issues, Vol. 41, 2007, pp. 11, 26