Pop! Why Bubbles Are Great for the Economy
by Daniel Gross
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Joseph Schumpeter once explained that 'capitalism without the entrepreneur is socialism.' The same principle applies to bubbles: capitalism without bubbles is investment socialism. In a world where individuals—with all their specific quirks, passions, and local information—make the investment decisions, rather than government committees of experts, the result will inevitably involve bubbles. Like entrepreneurs, bubbles are a natural and normal part of the capitalist process.

John Maynard Keynes famously said in his *General Theory* that whenever 'the investment activity of a nation is the byproduct of a casino, the job is likely to be ill-done.' He had in mind the Great Depression, which was the result of the credit bubble of the 1920s. However, as Daniel Gross points out, among the consequences of that was not just the Depression, which soon passed, but also the 'financial new deal' that furnished the regulatory infrastructure that eventually gave us mass consumer credit markets, the results of which included spurs to the durable consumer goods markets, and the widespread stock ownership that powers the growth of the financial economy to this day.

The key difference between Keynes and Schumpeter was their time horizons in the evaluation of capitalism's handling of individual investment decisions. Keynes thought the short-run disruptions of new ideas were too high a price to pay for them, and so he opened the door to investment socialism. Schumpeter, along with Hayek, thought that in the long run we, and our children, continue to live and to imagine new possibilities, and that the innovative consequences of the competition of individual investment decisions are dynamically superior to any centralised approach to investment. In this evolutionary view, bubbles come and go, but each time, like a fleeting artistic movement, they lay the foundation for the next space of opportunity. Bubbles are disruptive in the short run, but are part of the dynamic evolutionary process by which the new long run emerges.

Still, there remains a widespread fear and mistrust of bubbles due to the manifest short-run pain they cause. The call for government to do something about this perennial scourge is always politically popular. Bubbles are widely, yet wrongly, attributed to irrationality or the effect of mass behaviour. Robert Shiller called this 'irrational exuberance,' which inevitably results in a messy disruption of the economic order, both as bubbles inflate and after they 'pop.' The net result, in this view, is always a fleecing of the gullible, the contrition of all participants, and a recession, at very least. The seemingly endemic nature of bubbles is therefore part of the folklore of why capitalism is bad, and why in a 'rational society' there would be no bubbles because like other species of gambling they would be strongly discouraged by legislation. Bubbles, in this sense, are an inevitable consequence of putting the investment capital of a nation in the hands of private individuals, and of the passions they feel and the 'bets' they consequently make. Yet those who think bubbles are bad must then carry the implication that the capital investment of a nation should not be in the hands of such emotionally labile creatures as individuals, for when it is the result is bubbles.

Gross, a financial journalist for *Slate*, has called this implication utter nonsense. Rightfully so, many economists and economic historians have outlined the connection between bubbles and capitalist success, including myself ('Liberty Bubbles,' *Policy* 20:3, Spring 2004, 15–21). Gross's perspective is somewhat historically inaccurate, presenting bubbles as if they all came from America and were due to the unique nature of American capitalism. This is an absurd conjecture. Perhaps his editors and publishers insisted on this focus, thinking no one outside America would read *Pop!*, or that if they did, it would not matter. This plainly weakens his argument, and raises doubts about his reading of the literature cited.

Yet this is an academic quibble. Gross's central insight is that bubbles look good from the perspective of longer-term hindsight, and that governments should stay out of the way. The book develops this thesis through the investigation of six bubbles. Three of these were in the distant (American) past: the bubbles caused by the telegraph (1840–1860s), railways (1860–1890s), and the new financial deal (1920–1930s). The other three are recent and ongoing: those bubbles focused on the internet (1990s), real estate (2002–present), and alternative energy. Gross presents well-formed and highly readable overviews of these episodes, although the interested reader is, I think, better directed to their source material, especially Charles Kindleberger's *Manias, Panics and Crashes*, Edward Chancellor's *Devil Take the Hindmost*, and Carlotta Perez's *Technological Revolutions and Financial Capital*. Nevertheless, Gross's book is admirable because of four specific things.

First, Gross outlines the economic benefit of bubbles in terms of the development of the new infrastructure they bring. From the telegraph, to the railways, to the internet, private bubble investment has seemingly overbuilt infrastructure that, in short order, created the conditions for new business models based on this 'high bandwidth traffic,' which became the foundations of subsequent growth and development. Google and Skype, for example, would not exist today were it not for the bubble-inspired bandwidth build-out of the internet, in the same way that modern finance and retailing would not have existed without the bubble-inspired communication and transport build-out of the telegraph and railways.

Second, Gross puts the case for why government should do nothing about bubbles, and certainly not seek to foreclose upon them. As he writes, 'it is difficult to see how entities as fallible and error-prone as state and federal governments could manage bubbles successfully' and that 'given the long term benefits they can produce and their potential to help forge new industries, bubbles shouldn't be feared so much as regarded with concern and respected.' Gross is clearly in the Hayekian camp on the ability of governments to manage bubbles, and also in the inherent value of bubbles to the economic order. 'In the economic realm,' he writes,

> a little rebellion, now and then, is a good thing too. And bubbles, entrepreneurial storms that disrupt the existing commercial order, provide shots of adrenaline. The enthusiasm they generate has led successive generations of entrepreneurs to open new territory for settlement, to create valuable new infrastructure, to spur innovation, and to push people to work, invest, and spend at a higher level—all in pursuit of promised massive short-term gains.

In making this argument, Gross misses the deep implications of Schumpeterian and Austrian economics on the theoretical point of this 'bubblicious' concept, as he puts it. Yet he does hit upon an important policy point: bubbles, and the infrastructure they lay, are the product of individual investment action, not of government action.

Third, he advances the case for new bubbles. This is the most interesting aspect of the Gross thesis, and specifically because of his identification of the newest new bubble: alternative energy. This is the subject of his chapter seven, but I wish the whole book had been about it. Everything else in the book, including the very notion of bubbles as capitalist goodness, is a journalistic reworking of other people's ideas. But the idea of an alternative energy bubble is Gross's own, and he expresses it well. He argues that there is a current bubble in alternative energy (ethanol, solar, and wind) and, furthermore, that this is a good thing we need more of. His point is that unless we allow this bubble to develop and run, and brace ourselves for the inevitable 'pop,' we will never get the benefits of a market-capitalist exploration of the solutions to this problem. This is what the likes of Al Gore and others have never understood: the distributed power of individual initiative under experimental conditions can achieve, in the long run, far more than any government-sponsored solution ever could.

The fourth and final thing that makes *Pop!* admirable is Gross's discussion of some principles of how to invest in bubbles. He emphasises that aggregators or consolidators are a poor or risky bet on the way up, but a much better bet after the pop. He suggests bandwidth-hungry business models that depend upon falling unit costs of the use of the network infrastructure are good bets, as are those that go long on the commodities underpinning the new bubble-built infrastructure.

It occurs to me that a missing market here is the 'bubble fund': a hedge fund that explicitly bets long and short on these different aspects of bubbles. So… Who has a spare billion I can borrow to start one?

Reviewed by Jason Potts