



MARKET RISK AND EFFICIENCY

Taming Global Village Risk II: Understanding and Mitigating Bubbles

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Asset bubbles and their subsequent bursts are nothing new. Indeed, they have been a part of capital markets since modern capital markets began to evolve in the 17th century. While each bubble environment has its own distinguishing characteristics, most bubbles share certain common elements — financial innovation, the emotions and psychology of investors, and leverage.

They often begin with a focused innovation that initially benefits society at large but then draws speculators who leverage themselves in hopes of achieving even greater success. Increased complexity and unfounded claims soon take over, and a market imbalance emerges.

Eventually, the bubble bursts, inflated asset prices rapidly fall, the previously “infallible” innovation is placed in context, and investor rationality returns. These lessons, however painful, will hopefully provide the foundation for enlightenment and strength in the future.

One key is a strong, yet flexible, oversight framework having the goal of identifying and containing areas of excessive economic risk.

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