The dot.com bubble
Types of economic bubbles

Narrator
So what exactly is the definition of a bubble?

David Llewellyn
‘People buy simply because they believe that everybody else is going to buy.

You get what is called a bandwagon effect and from time to time, you then get a situation where prices go far too high, and that is really what we call a bubble.’

Narrator
Bubbles are characterised by volatility, with shares swinging from wildly over, to wildly under-priced – often in a matter of minutes.

Mariana
‘Robert Shiller, from Yale University, talked about bubbles arising from irrational exuberance, and what he’s done to actually measure bubbles, is he’s defined excess volatility to mean the degree to which stock prices are much more volatile than the underlying fundamentals which in theory they’re tracking.’

Narrator
There are also more specific types of bubble.

James Montier
‘The first form of bubbles are what might be called “bubbles of belief” or fads.

These are bubbles that are really driven by hype.’

Narrator
The ‘tulip bubble’ in 17th-century Holland was a good example of this.

Flowers were traded for up to ten times the annual wage of a skilled craftsman, or in exchange for a six-bedroomed house.

One bulb sold for 6,000 Dutch florins at a time when a ton of butter cost just 100.

In 1637 prices collapsed meaning they were no more valuable than onions.

Narrator
Britain's South Sea Bubble of 1720 was another bubble of belief.

Set up to trade in South America, the South Sea Company’s promise of huge growth led to fevered speculation.

Martin Wolf
‘Sir Issac Newton who bought shares in the South Sea bubble, made an enormous amount of money, sold the shares, he was fine.

And then he saw it going on up and he bought again and he lost it all.’

Narrator
After losing £20,000, he observed that he could ‘calculate the movement of the stars, but not the madness of men’.

Narrator
James Montier calls the next type of bubble an ‘intrinsic bubble’.

James Montier
‘These are bubbles in fundamentals, rather than actually bubbles in prices. So the behaviour of the financial sector in the last seven or eight years might be regarded as an intrinsic bubble, because they geared up so it looked like they were actually very profitable, but in fact it was all just leverage.’

Narrator
Another type is known as an ‘informational bubble’.

James Montier
‘Certain parties in the market will know information that other parties don’t, and they may not transact on that information, so not all information is properly reflected in prices. They tend to be very stock specific, rather than market-level events.’

Narrator
On a wider market level, the price increases in UK housing from the late 1990s until 2007, are seen by many economists as a classic bubble.

John Calverley
‘In my view, the big rise in house prices in the UK and some other countries in the last ten years is a bubble. Some people argue that with the low interest rate environment we’ve had in the last several years, with the lack of housing supply and so on, that the high price of houses are justified. I don’t think that’s right. I think that what’s happened is we’ve seen people convinced that house prices would forever rise and they’ve been buying bigger houses, more expensive houses than they otherwise would need. We’ve actually had an excess demand created by the view that house prices would always go up.

And I think for me, that’s what justifies calling it a bubble.