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WILL A FINANCIAL BUBBLE POP IN 2013?

The economic implosion of 2008, tech bubble bursting in early 2000s and the 1997 Asian Financial Crisis are popped financial bubbles. Yet such bubbles go back to the tulip mania in 1600s and the origins of the Great Depression of the1930s are two other such bubbles, further back in time.

Yale University lecturer and global equity investor Vikram Mansharamani in "Boombustology: Spotting Financial Bubbles Before They Burst" proposed five lenses to spot financial bubbles and make the necessary moves before it's too late: microeconomics, macroeconomics, psychology, politics and biology. Every lens provides some insights into how bubbles are created and any combination of those lenses spells trouble.

The two elements of microeconomics are supply and demand, which always find a way to achieve the so-called "equilibrium." However, monetary policies often come into picture, which can tip the balance. Thus, both Milton Friedman and John Maynard Keynes' arguments have their own strengths and weaknesses in the creation of financial bubbles.

George Soros' theory of reflexivity notes that human limitations come into the picture in shaping people's thinking. The delta between the reality and people's own perception creates an antithesis to "achieving equilibrium." In other words, economic "equilibrium" can never be achieved because people are in constant dynamic "disequilibrium."

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In macroeconomics, debt and deflation affect asset markets and prices. Hyman Minsky, a professor of economics at Washington University at St. Louis, posited that income-debt relationships are directly affected by people's ability to pay principal and interest. Using the psychology lens, the assumption that human beings are "rational" is a fallacy. According to studies, people are limited and motivated by cognitive biases. The studies also found that people are likely to make suboptimal decisions and adopt false assumptions. Hence, human beings are more irrational than rational. In addition, studies have found that human beings tend to be overconfident of their ability and are unaware of their limitations, which why experts offered "rational" explanations of bubble phenomenon without recognizing that they were already in a bubble.

The fourth lens is politics. A political-economic system greatly affects the likelihood that a financial bubble will occur. In the former Soviet Union, no bubble occurred as the state controlled prices and demands. In contrast, the more capitalistic a country, the more volatile are the market and prices. In extreme cases, such volatility will snowball into extreme prices leading to bubbles. Political will, which is often reflected in tax provisions and protectionism, further affects the creation of bubbles. For instance, in the U.S. mortgage interest is tax deductible. These provisions consequently create asset-class bubbles.

The final lens used is biology. After all, human beings are animals. The feverish intent to purchase a "McMansion" during the height of the mortgage fever in early 2000s is a symptom of financial disease, which spreads like wildfire with its infection. Studies had been done on large groups, which are called "emergence" and that transform themselves from chaos into group actions. Studies conducted on groups resulted in three behaviors: avoidance, alignment and attraction. However, people also show such behaviors in making economic decisions. Finally, are there any financial bubbles in 2013? Yes, and including the extent to which people are willing to spend on "investments." F

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