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Instant Info Is a Two-Edged Sword

The Internet facilitates markets, and bubbles.

By PAUL H. RUBIN

Bubbles have always been part of markets. The 17th century Dutch Tulip mania and the 18th century's South Sea Bubble are part of capitalist folklore. Recently, there seems to be an increase in the number and severity of bubbles and crashes -- Internet stock prices, housing prices and the stock market come to mind.

Markets have been good to us; even with the current crash, America is incredibly wealthy. The Internet and its progeny, such as email and online trading, have greatly increased the efficiency of markets. Ebay, Amazon, Etrade and many specialized Web sites have facilitated trade and created billions of dollars of wealth. Transaction costs have been greatly reduced, information flows quickly and effortlessly across markets to millions of potential traders and investors, and what economists call "market imperfections" are greatly reduced.

It may be that bubbles and crashes are a natural part of capitalist markets. What's more, it may be that the very factors that have recently increased the efficiency of markets have also led to an increased propensity for bubbles.

Consider: Information flows over the Internet mean that anyone in the country or even in the entire world (see Iceland) can learn about possibilities for apparently profitable investments during the run-up phase of the bubble. Anyone can learn about the tremendous profits from investment in Florida condos, or in the latest tech stock, or from hedge funds. Potential investors no longer need rely on word of mouth to learn about the latest rage. (Bernard Madoff did seem to rely on this method to find investors.)

Moreover, one does not have to visit Florida to learn about specific properties for sale or study a company's accounting records to learn about the newest big thing in technology: Complete information about properties, prices, locations and mortgage terms -- or about profits and losses and prospective earnings -- is readily available from a simple Google search.

Not only do we have instant information, reduced transaction costs make it easy for anyone to participate. Stock trades are virtually costless. Better information means that credit ratings, and therefore credit, is instantly available (though lenders must choose to use the information). Email and text messaging means that communication between potential investors is free and nearly instantaneous.

So the Internet does not only facilitate the functioning of markets; it may also facilitate their malfunction.

What does this mean? First, we can be sure that more regulation of financial (and perhaps other) markets is coming. The regulators have a difficult task: It will be very hard for them to eliminate the downside of the Internet and other improvements in financial markets without simultaneously eliminating the benefits.

For example, mortgage-backed securities really do facilitate easier financing of houses, but they can also feed a bubble. Economists and others interested in efficient regulation will have a difficult time in saving the benefits and eliminating the costs. It may not be possible: We may have to live in a world of high growth punctuated by bubbles. Maybe the best the regulators can do is try to moderate the severity of crashes.

As for investors, I knew many people who -- even decades after the stock-market crash of 1929 -- refused to invest in stocks at all. Some of these people were seriously harmed by the great inflation of the 1970s because they were invested in fixed-return assets such as bank accounts and insurance policies.

Many potential investors are again scared of financial markets. One possibility is that many people will follow the post-1929 pattern and refuse to invest in financial assets. This will cost them because, in general, stocks pay quite well. Moreover, it will starve American industry of profitable capital investments.

Other investors may accept the inevitability of bubbles and rely on their own ability to outguess them. An investment in a bubble is not a bad personal investment if one gets out soon enough. But of course we cannot all do that, or we just start the bubble bursting sooner.

The most hopeful possibility is that investors will have learned that there are good investments but that nothing grows forever. As we used to say at the Federal Trade Commission, "If it sounds too good to be true, it probably is." Then those who warn about excess will be believed, and bubbles may be aborted before they start. Alas, as recent events have shown, we can't count on this solution either.

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