Bubble Economics

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An asset price bubble is, loosely speaking, a situation in which the asset price is too high to be justified by fundamentals. Kindleberger (2000) documents 38 episodes in the 1618–1998 period. Jordà, Schularick, and Taylor (2015) study bubbles in housing and equity markets in 17 countries over the past 140 years. Famous examples are the 1630s tulip mania in the Netherlands, the South Sea Bubble of 1720 in England, the Japanese real estate and stock market bubble of the 1980s, and the U.S. dot-com bubble of the late 1990s and the housing bubble of the early 2000s, among others.

This article provides a self-contained overview of the theory of rational asset price bubbles. We cover topics from basic definitions, properties, and classical results to frontier research, with an emphasis on bubbles attached to real assets such as stocks, housing, and land. The main message is that bubbles attached to real assets are fundamentally nonstationary phenomena related to unbalanced growth. We present a bare-bones model and draw three new insights: (i) the emergence of asset price bubbles is a necessity, instead of a possibility; (ii) asset pricing implications are markedly different between balanced growth of stationary nature and unbalanced growth of nonstationary nature; and (iii) asset price bubbles occur within larger historical trends involving shifts in industrial structure driven by technological innovation, including the transition from the Malthusian economy to the modern economy.