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BOOK REVIEWS

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Ali Kabiri, **The Great Crash of 1929: A Reconciliation of Theory and Evidence**, Palgrave Studies in the History of Finance (Basingstoke: Palgrave Macmillan, 2014, 256 pp. ISBN 9781137372888 hardcover and ebook)

Ali Kabiri (Lecturer in Economics at the University of Buckingham and a Research Associate at the LSE Financial Market Group) has added to the literature on the 1929 Great Crash a new and interesting book that also speaks to the current debate on the recent global financial crisis. As the title suggests, the book is a mixture of modern financial theory and fresh historical evidence. Readers will find three main original contributions: new data for the 1900–30 period; a valuation model for the aircraft industry (the high-tech industry of the time); and an analysis of returns for a new investment vehicle (an index tracking fund). To avoid the pitfalls of hindsight, Kabiri uses the information and the models that were available to investors at the time, in order to check whether a bubble could be identified ex ante.

The volume raises a thorny question: was there a bubble – defined as a positive 'deviation of asset prices from their ex-post observable fundamental values' (p. 21) – in the US financial market of the 1920s? If so, what were its determinants? In his search for an answer, Kabiri takes stock of the 'efficient markets hypothesis' vs 'irrational exuberance' debate, but also discusses new financial theories and asset pricing models that emerged in that period, especially a 1924 study by Edgar Smith on 'Common stocks as long term investments'. The author's conclusion is affirmative: although in 1927 the stock market was not overvalued, by 1929 the deviation from fundamentals had reached 50 per cent (p. 23). The bubble was not over until the mid 1930s.

The book provides a general framework for the analysis of stock market developments by discussing extensively the characteristics of the US financial system, the transition to the Gold Exchange Standard and the emergence of a shadow banking system. Kabiri empirically tests a number of factors that might have influenced stock prices, including institutional innovations in the investment industry, technology shocks and a credit cycle. The 1920s was notoriously a period during which an increasing number of investors began to participate in the stock market. New ideas on risk, uncertainty and investment emerged, and a new type of investment vehicle – the closed-end fund – became popular. Kabiri explores how new theories about the risk premium and the expected growth of stocks could have influenced investors. However, he finds that their role was negligible, as institutional innovations such as closed-end funds could have only a very modest impact on prices. As for technology shocks, Kabiri focuses on the aviation industry. Similar to stocks of other emerging industries of the recent past (railways, oil, telegraphs, automobiles and the radio), stocks of the aviation industry could be overvalued in the 1920s. By using valuation models available to investors of the time, Kabiri finds that, compared to the performance of automobile stocks, aviation stocks were significantly overvalued but could not explain the global overvaluation. Finally, what about the role of credit? In fact the stock market boom was accompanied by a strong credit expansion, and the Federal Reserve's attempts to limit loans to traders from regulated banks and funds were easily circumvented by raising loans from alternative sources. However, he finds no evidence that a credit crunch caused the Great Crash by forcing investors to sell.

Having stated that there was a bubble, the book looks for drivers of the potential overvaluation by looking at the 'usual suspects' such as dividend and earnings growth rates, size and momentum. Kabiri finds that none of these caused the overvaluation (neither at the aggregate level nor when looking at the cross-section of stocks), although momentum effects are present but weak. 'Irrational behaviour' would be an alternative explanation, as possibly investors believed 'a new era' had arrived.

Although Kabiri's main focus is the stock market Great Crash of 1929, the Great Contraction of the early 1930s is also examined. While an optimism-driven bubble led to the former, the latter was a sort of 'anti-bubble' driven by investors' profound pessimism (p. 180), which led to an estimated undervaluation of 45 per cent in 1932. In line with the literature, the Great Contraction is interpreted as the consequence of a shock caused by repeated waves of banking crises and a fall in aggregate demand; at the same time it is suggested the collapse of stock prices also had an effect on the real economy.

The book does not pretend to offer a comprehensive historical analysis of the period between the Great Crash and the Great Contraction, as its main objective is to analyse the boom in the US stock market. Perhaps the study of comparable stock market bubbles and crashes could be added to an already impressive agenda for future research outlined at the end of the book.

Kabiri's work deserves to draw the attention not only of an academic readership, but also of policy-makers. The role played by the 'invisible banking system' in the boom of the 1920s is a reminder of the systemic risk brought about by shadow banking. His discussion of asset bubbles also provides a research agenda that can contribute to preventing their formation, with a special emphasis on financial education. Overall the book is an original contribution to the vast literature on the Great Crash and the Great Contraction. The combination of original data, historical models of stock market valuation and new insights from recent research in financial makes this book valuable reading for scholars in a wide range of fields, including financial history, behavioural economics, neuro-economics, empirical finance and the history of economic thought.

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