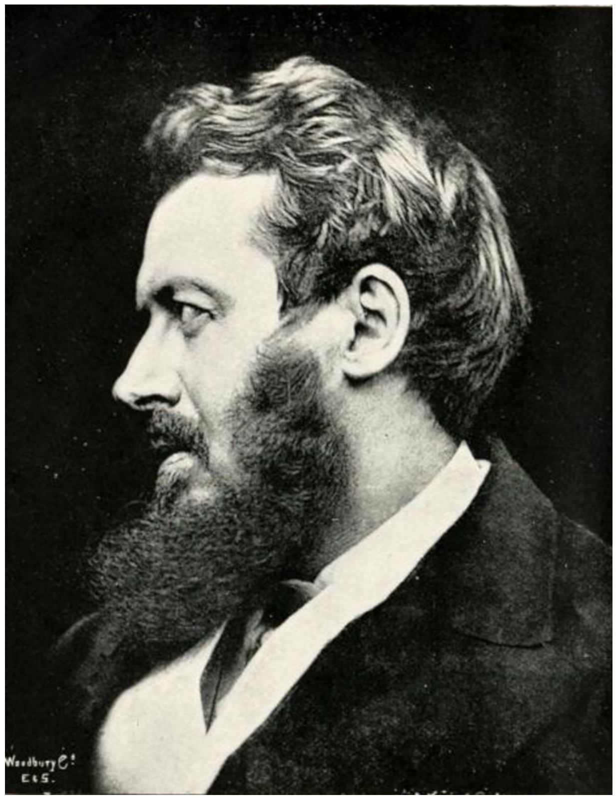
The History Of The South Sea Bubble



One thing is certain, that at particular times a great deal of stupid people have a great deal of stupid money... At intervals, the money of these people — the blind capital, as we call it, of a country, is particularly large and craving; it seeks for someone to devour it, and there is a 'plethora'; it finds someone, and there is speculation; it is devoured, and there is 'panic'. ~ Walter Bagehot

Bagehot (pronounced Bajut) served as editor of *The Economist* between 1861 and 1877. His words above have shown up in countless trading and economic books over the years and were originally from an essay titled *Edward Gibbon* (essay can be found here).

Mr. Gibbons happened to be a board member of the Hollow Sword Blade Company, which occasionally made arms for the British military, but primarily operated as a bank. The Hollow Sword Blade Company and Mr. Gibbons are of note, because they were both pivotal characters in the South Sea Bubble -- one of the greatest stories of financial folly and human irrationalism in history.

The tale of the South Sea Bubble is great for two reasons: 1) It involved some very recognizable names from history including but not limited to King George (King of England), Daniel Defoe (author of *Robison Crusoe*), and even Sir Isaac Newton himself; and 2) it's a perfect historical example of the collective lunacy that human beings are not just capable of, but seemingly prone to, under certain conditions. And it's this second point that we're going to explore today.

To begin, let's first briefly recount what happened in England (England didn't become Great Britain until the middle of this tale) some 300 years ago.

At the start of the 18th century England was racked with debt. The country had been fighting wars for the better part of the century and was having trouble financing its deficit.

Faced with the two options of either raising taxes or cutting spending — both unpopular and difficult because England was still engaged in an expensive war with the Spanish — the government decided to invent a third option... Central Banking!

The King got together with a group of bankers to form the Bank of England. These bankers got an exclusive license to issue English money, and in return, would loan the government all the money it needed at a fixed rate. The money lent to the government was simply created out of thin air — backed by only a fraction of collateral, which was of course, kept secret from the public.

So the Bank of England was pretending to make a loan to the government when it was really just printing money for the government to use — this is called pretense. The government couldn't just print the money itself because then the people would see the scheme for what it really was, a sham! That would lead to vendors not accepting payment from the government in the form of English notes… because they would know those "fiat" notes weren't worth much.

The key to carrying out successful financial chicanery is that the process needs to be opaque and very convoluted. And as we're going to see, the BoE debt monetization scheme was just the start.

The English government, which at the time was run by the Tories, wanted to finance even greater deficit spending. But they started to run into problems because the BoE was controlled by the Whigs, who limited their funding. The government had to once again look for another option.

Around the same time a company called Hollow Sword Blade created a new financial product — one of the first debt-for-equity swaps. Except it wasn't really a "product", but rather more of a scheme to swindle the public. The company offered to exchange unsecured government debt issued by the army for shares in the Hollow Sword Blade company.

Unbeknownst to the public, the company had been amassing large holdings of the Army's debt at a deep discount because the quality of the credit was questionable at best.

The debt-for-equity swap drove up demand (and thus price) for the army's debt. The Hollow Sword Blade Company then took the now more valuable army debt and exchanged it back to the government for government owned land in Ireland. The company made a profit, the public got shares in a company that now seemed to be making money, and the army got to finance its spending. Everybody wins… and we have one of our first instances of the financialization of an economy where "wealth" is created out of thin air.

The Chancellor of the Exchequer (which is the English equivalent to the Secretary of Treasury) was desperate to find funds and when he saw how successful the Hollow Sword Blade debt-for-equity swap was, he reached out to the company for help.

The South Sea Company (SSC) was born out of this partnership in 1711. The company was a public-private partnership formed to consolidate and reduce the costs of the government's massive debt.

The plan was this: Similar to the Hollow Blade debt-for-equity swap, the South Sea Company would assume a portion of the government's debt. It would then offer its shares at par value in exchange to the public for the debt. The government would then pay a new lower interest rate on the debt to the company, which the company would pay out to shareholders as an annual dividend (opaque "check", convoluted "check").

But knowing that there would be little incentive to exchange high-yielding "safe" British debt for shares in an unknown company for a lower yield was no business plan. The plan architects needed a sweetener. The answer was for the government to give the South Sea Company a monopoly on trading in the South Seas (hence the name). The sweetener for the public then, was a compelling "narrative" and the potential for the shares to appreciate.

A minor detail was that the South Seas referred to the ports in Central and South America which were controlled by the Spanish at the time. And the British were at war with the Spanish. So initially the company had no access to the South Seas, for which it was named.

Not to be deterred by such trivialities of not having an "actual business plan" or any source of income other than selling shares… the public bought into the scheme hand over fist — it helped that the East India company (a legitimate trading company) was one of the most profitable companies at the time and South Sea Company sounded… well... similar enough. Also, the King was named ceremonial Governor of the company adding an air of legitimacy to the scheme.

It's trading operations never made money, it was purely a financial company. But as a financial company that practiced alchemy; creating wealth out of thin air… it was the best.

The plan worked well. The public bought up government debt and traded it for shares in the South Sea Company. This caused the stock price to rise, which spurred more interest in the company and created more demand for government debt to exchange for shares… and a positive feedback loop was created.

As the share price went up, the shareholders felt wealthier and a "wealth effect" was created. People started to take out loans using their rising SCC stock as collateral and then spent their money in the real economy. A credit boom was created.

Pretty soon other entrepreneurs saw how well SCC was doing and decided to start their own companies doing similar business; which was the business of issuing shares and promising large profits down the road (cough… Tesla and Thernos… cough) . And it worked.

Public companies started sprouting up that promised "flying machines" and "brain dehumidifiers"... and perhaps the best tagline for a stock issuance was "For carrying on an undertaking of great advantage; but nobody to know what it is." And people bought, because there was a credit boom and a wealth effect. And the new money in the system needed to go somewhere.

The plan looked like such a huge success that the SCC and the government decided that the company would consolidate and hold ALL of the British government's debt. This means that the company would have to issue shares equivalent to said debt… which was a lot of debt.

In order to help deal with the large supply of shares coming onto market, the company started offering favorable purchase terms to those wanting to buy the stock. They let people purchase stock with just 20% down, then 10% down, and eventually, they just started giving people loans to buy SCC stock.

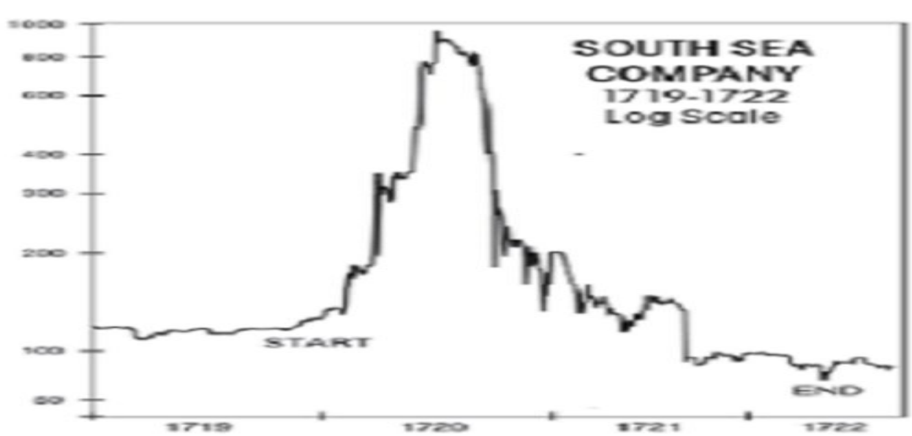
The stock price went from 100 pounds up to a 1000!

The South Sea company that had never made a profit from trading, was worth 300 million pounds at its height. It was owed over 60 million pounds by the people it had lent money to, to buy its stock, which was more than all the money in Britain. To put this all into perspective, on a value to national economy basis, in the modern US, the South Sea company would be worth roughly $90 trillion dollars.

Of course the thing blew up... Like all credit driven bubbles, it inflated on ever more extreme promises and beliefs. If finally reached a point where the promises being made by the company were so ridiculous and the price so far removed from any possible realistic outcome that demand evaporated. When demand disappeared, the price of the stock fell.

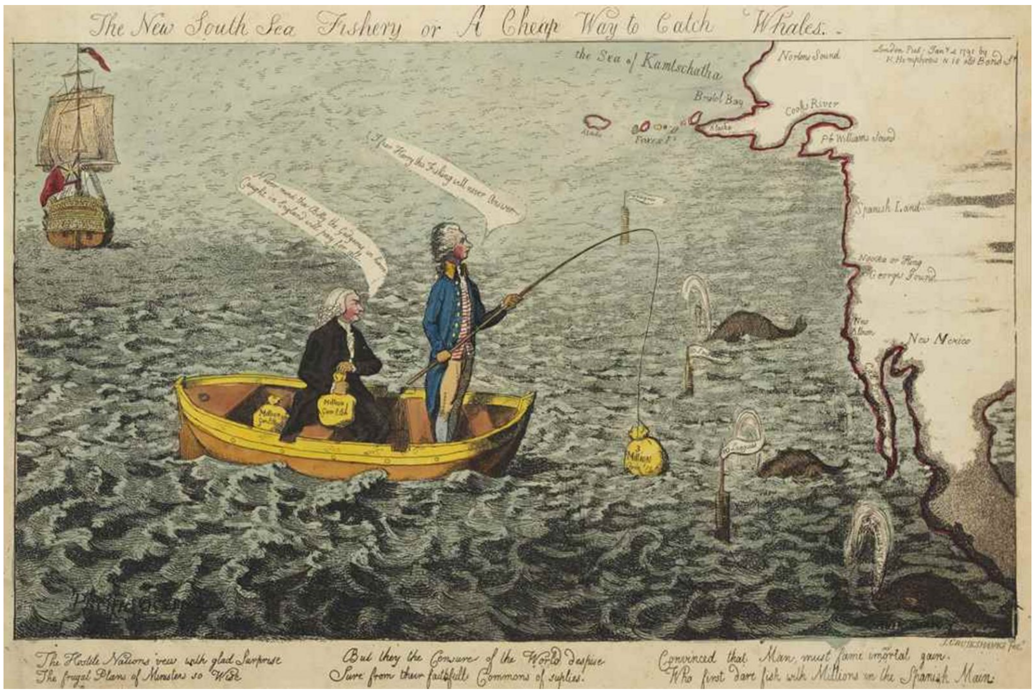
When the only reason people are willing to do mental contortions to buy into a narrative is because the price is rising, and it suddenly stops rising… well, you know… price collapses and panic sets in. A feedback loop is put into reverse.

The stock collapsed to zero a short time later.



The insiders of the scheme sold out near the top… the unwitting public got Shanghaied with the bag.

There was outrage, trials, people were hunted down and made scapegoats… even though everyone was complicit. The truth of the scheme was easy for anybody to see. Anybody who was willing to look and think for themselves. But like all manias, it's was so much easier to join the mass delusion and buy into the belief that wealth can be created from nothing.



We like to think that we've evolved quite a bit since the 18th century, but we haven't. The South Sea bubble is no different than the 90's tech boom, or the subsequent housing bubble.

We are animals with short memories and a strong herd mentality. This fundamental part of our nature almost ensures that we will perform the mental gymnastics necessary to buy into a ludicrous story when we see other people getting rich off of rising asset prices.