PLUS ÇA CHANGE, PLUS C'EST LA MÊME CHOSE--
BUBBLES THEN AND NOW

Looking back at the infamous South Sea Bubble with the perspective of hindsight, we can see many of the same factors that are exhibited by the economic crises of today: unsustainable sovereign debt, a faulty financial plan to solve it, a bit of political corruption, a meteoric rise in stock prices, a market collapse, a political cover up and, in the end, a gratifying orgy of retribution. Although some of the more extravagant excesses of this, the ur-Bubble, are now illegal, the human impulses that caused England's first stock market crash haven't changed at all. Hence, my title: *"Plus ça change, plus c'est la même chose."*

Like many another financial debacle, the South Sea Bubble began as a grandiose plan to solve a festering sovereign debt crisis. Since the accession of William and Mary in 1689, England had been engaged in almost continuous warfare at sea and on the Continent. The costs were far greater that could be paid for out of available tax revenues. By 1697, the £1.2 million per year estimated cost of the wars, plus the ordinary expenses of running the Government, exceeded revenues from the Customs and Excise, Land, and Poll taxes by a cumulative total of £14-15 million.[1] This may seem a small number, but it was a crushing debt load for a country that in 1700 had a population of only 5 million.

The Whig government under Montagu and Godolphin tried various expedients to meet the mounting debts. In 1694, it sponsored organization of the Bank of England to act as its fiscal agent in managing service on the debts, and in 1695 it authorized the Bank to sell shares to the public in order to make the Government a £1.2 million loan at a favorable rate of interest. In 1697, the Bank was used in a new way to refinance some of the Government's debts by again authorizing it to issues shares to be exchanged for £800,000 worth of outstanding debts that were owed to unpaid suppliers of goods and services. The debts were evidenced by notched strips of hazel wood, called "tallies," that served as receipts for the goods and services and were to be presented to the Exchequer when funds became available for their payment. These tallies bore interest, and could be traded on the open market, albeit at a steep discount. The holders of these heavily discounted tallies readily exchanged them for the Bank's shares, and the Bank then gave the Government a better rate of interest on the tallies it had acquired.

These transactions with the Bank of England helped to some extent, but still the wars ground on and on. Following the outbreak of the War of Spanish Succession in 1702, the Government had to resort to more loans from merchants in the City of London

[1] David Ogg, England *in the Reigns of James II and William III* (1984), Chapter XIV (1984), Chapter XIV.

and to raising money by means of so-called "lottery loans" in which the prizes were annuities. All of these loans were secured by pledges of specific tax revenues, which made things worse by depriving the Government of revenues that would otherwise have been available to pay for current expenses.

War weariness forced out the Whig Ministry in 1709, and the Tories, lead by Robert Harley, later the Earl of Oxford, took over the Government with a program of negotiating a general peace. This was eventually accomplished in 1713 with the Treaty of Utrecht, but in the meantime Harley had to find a way to pay for what had by then become known as "the War to the Last Guinea." In this he received no help from the Bank of England, which was stacked with Whig directors who had no sympathy for the new Tory Government. Thus it was that Harley turned in 1710 to an alternate plan for refinancing the Government's most pressing obligations.

The plan called for the creation of a new company called "The Governor and Company of Merchants of Great Britain Trading to the South Seas and Other Parts of America," which would have a monopoly on the South American trade that was expected to develop when the on-going treaty negotiations opened up that territory to British commerce. Until then, the Tories could use the South Sea Company, as the Whigs had used the Bank of England, to refinance the worst of the problem debts.

The Company's principal organizer was John Blunt, a legal scrivener by trade, who had previously taken over a defunct manufacturer of swords known as the Sword Blade Company and tried to operate it as a land bank. This infringed the Bank of England's banking monopoly, and in 1702 the Sword Blade Company was forced to withdraw from the land bank business. Since that early peccadillo, Blunt had risen in the City to become one of Harley's principal financial advisers. In his new position of influence, Blunt was able to get a provision placed in the South Sea Company's charter that made the Sword Blade its banking affiliate. He also brought six directors of the Sword Blade, including George Caswall, Jacob Sawbridge and Edward Gibbon, the grandfather of the historian, into the new Company's directorate. These were the insiders. The rest of the 36 directors were mostly content with the prestige and fees that they earned for attending the infrequent meetings, and had little to say about day-to-day operations.

The legislation creating the South Sea Company also authorized its first financial venture, which was modeled on the Bank of England's 1697 debt refinancing. In return for a lower interest rate, the legislation called for the issuance and exchange of 900,000 shares of the Company's stock for £9 million worth of tallies that were held by small merchants and seamen. This, however, was not so good a deal as the Bank of England exchange transaction, because the value of the South Sea shares was wholly dependent on the outcome of treaty negotiations that had not yet been completed.

Anticipating a poor response to the projected offer, the organizers solved the problem by adding a provision in the charter legislation that made the exchange compulsory.

The skeptics' reluctance to make the exchange proved to have been fully justified. The final terms of the 1713 Treaty of Utrecht only gave England a limited concession to import slaves into the Spanish colonies, plus the right to make a single trading voyage each year to the Spanish possessions in South America--with the King of Spain to receive a 28% share of the profits! Although the South Sea Company did attempt to engage in such trade as it was allowed, its mercantile business was never successful. It thus was not at all comparable to the East India and other trading companies with substantial operations, or to its rival, the Bank of England, whose shareholders had paid hard cash for their shares.

Despite these weaknesses, the Company managed to survive and even enjoy a spectacular boom in the price of its shares before the inevitable crash. This feat of commercial levitation was accomplished through a combination of political astuteness and a real talent for manipulating the secondary market for the Company's shares.

On the political front, Harley was given the honorary position of Governor, similar to that of Chairman of the Board in a modern corporation. Another six or so Members of Parliament were also directors, and most of the rest were friends of friends in the Government. This practice continued when Harley's Ministry fell in

1714 during the Succession Crisis, and the Whigs under Charles Sunderland and James Stanhope were swept in with George I. Under the new regime, the Tory directors were replaced with Whigs and the Prince of Wales was made the honorary Governor, to be replaced with the King himself after the Prince fell out of favor with his father.

Packing the directorships with Government officials implied a degree of governmental support that helped make the stock attractive to potential investors, but convincing the stockjobbers who bought and sold stock in Exchange Alley would require more than a fancy set of directors. In the early 18th Century, this wholly unregulated secondary market was conducted in a collection of seedy streets and alleyways just outside the doors of the Royal Exchange, which at the time dealt only in commodities. The denizens of Exchange Alley had been trading in South Sea shares since the 1711 debt swap, when the small holders who were forced to accept the exchange had rushed there to convert a dubious asset into cash. The trade had continued apace ever since, and it was important to keep up the Company's share prices. This was the job of the Sword Blade agents who prowled the alleyways, and they were very good at placing well-timed rumors whenever the stock began to sag.

In 1718, when the prospect of yet another Spanish war threatened to end the Company's meager South American trade, Blunt rose to the occasion with a new plan to exchange up to 250,000 South Sea shares for £2.5 million in annuities that had been issued in the lottery loan of 1710. The annuities were drawing about 9%; under Blunt's proposal, the Company would accept 5% and lend the Government £750,000 on easy terms for the privilege of taking over the debt. This time the exchange would be voluntary, but it succeeded with a bit of luck when news that James Edward, the Stuart Pretender, had failed in the last of his inept attempts to regain the Throne drove the price of the Company's shares up to £114. This gave the Company a 14% premium on the exchange, which made it possible for it to sell the shares it did not need for the exchange, use some of the proceeds for the £750,000 loan to the Government, and pocket the difference.

The success of this operation led to a much grander scheme to take over all of the National Debt, which by that time had risen to some £31 million. As before, the basic idea was to agree on new terms for payment of the outstanding claims and then acquire them in exchange for South Sea shares. Negotiations for the refinancing began in November, 1719. Blunt and Robert Knight, the Cashier, represented the Company; the Government was represented by James Craggs, son of the Postmaster-General and a financial adviser to the Government, and John Aislabie, the Chancellor of the Exchequer. The parties agreed that interest on the debt would be reduced to 5% until 1727, and to 4% thereafter. In addition, the Company would make the government a gift--not a loan--of £3 million. The proposal seemed feasible, since the market price of the stock had by then risen to £126 and any bargain with the debt holders between £100 and £126 would produce enough profit to pay the Government's £3 million sweetener several times over.

Alas, politics intervened to ruin a sound plan when a back-bencher in the House of Commons objected that there had been no competing offer from the Bank of England and the House adjourned to await an offer from the Bank. The Bank, by now thoroughly alarmed by the prospect that a successful refinancing would leave it high and dry as a Government lender, entered the bidding by offering the same terms with a £5.5 million sweetener. The South Sea Company then raised the ante to £7.5 million, plus a further reduction in the interest rate. The Bank's second counter was not nearly so good, so the House accepted the South Sea proposal and sent the matter back to Chancellor Aislabie, Postmaster Craggs and First Lord of the Treasury Stanhope to redraft the Bill.

While the revised Bill was being drafted, Knight was busy gathering "friends" who could help with passage of the Bill. Beginning in February with the key insiders, Knight fictitiously "sold" 5,000 South Sea shares at the then market price of £175 to Sunderland, the Whig Party leader, on the understanding that the Company would buy them back on demand at whatever the future market price might be. This meant Sunderland stood to gain £500 for every point that the stock rose above £175. Postmaster Craggs got 3,000 shares on the same terms. Chancellor of the Exchequer Aislabee really pushed, and got £200 for every point above £130 per share, at a time when the market price had already gone to £180. George I's mistress, the Duchess of Kendal, and Craggs' mistress, Countess van Platen, were similarly favored with lucrative sale and repurchase deals.

By the time the revised Bill had passed the House and moved on to the Lords, twenty-four M.P.'s and four Peers had also joined Knight's group of "friends." Needless to say, the Bill sailed through the Lords and became law when it received the Royal Assent on April 7, 1720. Significantly for the coming storm, Knight had carefully recorded all of the transactions with his "friends" in what a witness later referred to as his "ledger book with green covers."

Although the Company had won the bidding war with the Bank, the new deal terms and the additional expenses of getting the Bill passed had raised the break-even point on the proposed exchange from the old target of £127 per share to a new target of £400 per share. Since the Company would again need to sell shares to the public in order to get the cash it needed to pay the £7.5 million sweetener it had promised the Government, and the £2 million or so in bribes it had contracted to pay various political figures, the share price *had* to reach that target—or else.

To get the desired levitation process started, the Company offered 20,000 shares for public subscription on April 14 at £300 per share. Due to the excitement among Knight's "friends," and aided perhaps by the buzz generated by the Sword

Blade agents in Exchange Alley, the offering was over-subscribed, so that an additional 15,000 shares could be offered and sold on April 29 at £400 per share.

Sale of the subscriptions was helped along by generous terms that allowed subscribers to buy shares for a modest down payment, with up to 9 quarters in which to pay the balance due. The second subscription was made even more attractive by an offer to lend subscribers money on the security of their stock, with the loans being funded with the proceeds of the first subscription. Using the proceeds of the first subscription to fund loans in the second subscription was like a Ponzi scheme, only better, because a Ponzi scheme does not re-circulate the cash payout back to the issuer.

Having pushed the market price of the stock up to £400, Blunt was now ready to announce the tender terms for the most intractable portion of the outstanding claims, consisting of £14.5 million in irredeemable annuities that had been issued in various past lottery loans. At the time, the market price for a 99 year irredeemable annuity that yielded £100 a year was about £1,600, or 16 years' purchase. Blunt offered a package of stock, notes and cash worth £3,375, which was a very good deal if you believed the seven shares of South Sea stock in the package were worth at least £375 per share. About a third of the annuitants did believe this, and accepted at once. To bring in the rest, Blunt announced that the Company would lend existing stockholders £300 for each share at 4% interest. This convinced most of the holdouts by sending the stock soaring to £460 and, when it became obvious that the exchange would succeed, the market price of the Company's stock rose again to £700.

To obtain the funds that would be needed to pay the cash component of the tendering annuitants' packages, the Company opened a third money subscription on June 17, this time offering 50,000 shares at £1,000 per share on even more generous credit terms than had been offered in April. Although the South Sea share prices fell back a bit from their June high of £950 or so, they were still holding at around £800 on August 4 and 12, when the Company made its exchange offer for what was left of the irredeemable annuities and for the £16.5 million in redeemable obligations that were his next target. Both offers were successful, with the result that the Company acquired 85% of the irredeemable annuities and more than 80% of the redeemables. In a single bold stroke, the National Debt had been converted into South Sea stock on terms that were highly favorable to the Government—a seeming miracle of public finance!

With no Paul Voelker around to "take away the punch bowl just as the party is beginning to get interesting," the feeding frenzy in South Sea shares spilled over into other ventures, legitimate and illegitimate alike. Like boats rising together on a rising tide, East India Company share prices increased from about £200 to about £400 per share, and Bank of England shares rose from around £125 to £350 or so. Newly rich investors rushed to buy fancy coaches, jewelry, other luxuries, land, and, of course, more shares, mostly on a credit that depended on the continued health of the stock market. And the hottest tickets in town were being sold in what we would today call the IPO market, where hundreds of new companies, many of them of dubious purpose and prospects, were being offered to eager and credulous buyers. Some of these so-called “mushroom companies” succeeded and survived into the modern era, but it was in the nature of things that most were destined to fail and, sadly, all too many were outright frauds.

Charles McKay’s *Extraordinary Popular Delusions and the Madness of Crowds* captures the madness with a possibly Apocryphal story about a promoter who offered 500,000 shares in "a company for carrying on an undertaking of great advantage, but nobody to know what it is." Subscribers could purchase shares for £100 each by depositing just £2 per share, with the balance to be due in one month after disclosure of the nature of the “advantageous undertaking.” Deposits amounting to £2,000 were received the first day. McKay concludes that the promoter "was philosopher enough to be content with his venture, and set off the same evening for the Continent. He was never heard from again."

This flood of new stock market activity conflicted with Blunt’s need to keep up the price of South Sea stock, which would be harder to do if investors had alternative uses for their money. To stem the flow of funds into the host of new companies that were being formed in the wake of the South Sea price advances, the

Company's "friends" in Parliament passed what became known as the Bubble Act. This law, enacted in July 1720, put a moratorium on new company charters, prohibited informal joint stock companies from operating without a charter, and required existing companies (except, of course, the Sword Blade) to operate strictly within the scope of their charters. This dampened the speculative frenzy and, for a while at least, kept Exchange Alley quiet.

But the quiet was ominous, as it was becoming increasingly clear that the price of South Sea stock could not stay up forever. Already, astute professionals and foreign investors were withdrawing from the market, and there was much nervousness among those who remained. Among those who withdrew early was Thomas Guy, who held 540 shares that at the time were worth over £150,000. Wishing to found a hospital, he began selling in late April in small lots of 10 shares or less. He cleared the whole portfolio in six weeks while the market went from £278 to £750, and got out with a £254,000 profit. Guy's Hospital in London, now operated by the Guy's and St. Thomas' Hospital Trust, honors his name to the present day.

Despite the gathering unease, the Company was still able to sell another 12,500 shares at £1,000 per share on August 24, 1721, and the market price of the stock held at £750 through August 31. After that, sellers started heading for the exits and the share price began an uncontrollable slide, falling by October 1 to £290 and by

December 1 to £128.[2] The South Sea stock was not worthless at this price, which in reality was a good approximation of the true value of the assets that the Company had acquired in the 1711 and 1721 exchanges. Thus, the shareholders who had bought at or below £128 lost only paper profits --"fairy gold" it was called. But the shareholders who acquired shares above that price, especially those who had exchanged secure annuities for stock that was now worth far less than its highly inflated April and August prices, lost heavily.

Typical of the many small investors who suffered in the crash was the daughter of the Rector of Exeter College, Oxford, who lost her £1,200 inheritance and had to endure the ultimate indignity of becoming a governess. The Duke of Portland was also wiped out, and had to ask for the governorship of Jamaica as a means of getting away from his creditors. Sir Isaac Newton, who had presciently sold his 700 shares in April at a 100% profit, but was lured back in later on, lost £20,000. For the rest of his life, no one could mention the words "South Sea" in his presence. Perhaps the saddest case was that of John Gay, who had received a gift of South Sea shares from the younger Craggs which at one point was worth £20,000. His friends urged him to sell in order to create a hedge against old age, but he

[2] Ironically, Blunt may himself have set off the slide by initiating a successful action under the Bubble Act against a syndicate that proposed to convert a mining company into an insurance concern. When the venture was blocked, the investors were forced to sell their South Sea shares to repay the loans they had taken out to make the investment. This set off a wave of selling that became a rout in September, when the Bank of England refused to accept notes issued by the Sword Blade Company.

declined and the fortune was lost. Dr. Johnson tells us in *Lives of the Poets* that the depressed Gay “sunk under the calamity so low that his life was in danger."

As the South Sea Company began to go down, an urgent message was sent to the King in Hanover to return as quickly as possible. In the meantime, Sunderland, Stanhope, Ainslabie and Craggs began negotiations with the Bank of England to save the Government–and themselves--by some form of rescue for the South Sea Company. At this point, Robert Walpole, who had been forced out in 1717, returned to the Cabinet to take a leading hand in the rescue operations. When negotiations with the Bank collapsed on November 8, he pushed the Sunderland group aside and took over completely.

The main object now was to keep the lid on a brewing scandal that, as Knight had ominously put it, could reach "even to the Throne." A host of outraged merchants and cheated annuitants were crying for blood. They were joined by the politicians who had lost heavily as the result of their having been afforded insiders' privileges to buy in at what turned out to be the top of the market. This group included 128 M.P's and 58 Peers who had pulled strings to get into the first subscription at £300 per share, and 352 M.P's and 119 Peers who were given special access to the third subscription at £1,000 per share. These people were no longer "friends,” nor was the King, whose £60,000 investment was now worth a bit less than £12,000.

In an effort to save Sunderland, the two Stanhopes, Craggs and Ainslabie, Walpole decided to support legislation which required the South Sea directors to provide a Committee of Inquiry with full access to the Company's books and, more significantly, to give the Committee a complete inventory of their personal wealth. The Committee's investigatory efforts were frustrated to some extent when Knight absconded across the Channel with the famous "green covered ledger book." He was eventually apprehended near Liège, but the book was gone forever and the authorities in Brabant refused extradition. Even so, it was clear that there had been extensive corruption at the top and, although there were no laws that exactly fit the case, the pressure grew to try the responsible politicians for corruption.

Walpole's efforts to protect the top five Whig Ministers from criminal prosecution, which earned him the title of "Screen Master" to go with his official position as Paymaster of the Forces, were mostly successful. Three of the Committee's targets were beyond the reach of justice: James Stanhope and the younger Craggs died in the course of the investigation, and the elder Craggs committed suicide. However, aided no doubt by Knight's disappearance and other evidentiary lacunae, Walpole's skillful obfuscation did help to secure acquittals for Sunderland and Stanhope's brother Charles. Only Ainslabie, the guiltiest, was convicted and briefly imprisoned in the Tower. But Sunderland's political career was over, and in April he resigned the Treasury to Walpole.

Another product of the Committee of Inquiry's work was a statute called the South Sea Sufferers Bill. This law called for forfeiture of the now-deposed directors' net assets, after deduction of an appropriate amount to provide for their future support. Acting pursuant to the Bill, the Committee went through the net worth statements the directors had been required to present in the previous winter, reviewing them one by one to determine what allowance each director would receive for his future maintenance. Of the worst offenders, Blunt was allowed £5,000 out of a net worth of £183,000; Sawbridge £5,000 out of £21,000; Gibbon £10,000 out of £106,000. The forfeited estates were eventually reduced to cash and transferred to the Company for the benefit of its shareholders.

Although the Sufferers Bill only applied to the Company's directors, the Committee was determined to make an example out of the responsible Government officials as well. Once more into the breach, Walpole intervened to protect Ainslabie and the elder Cragg's estate, although not necessarily for purpose of aiding his fallen comrades. Thanks to Walpole, Ainslabie got off with £120,000 to support country life on his estate at Studley Royal near Ripon, and thereafter Ripon returned two members who faithfully supported Walpole's Ministry as long as it lasted. Walpole also saved one third of the elder Cragg's £1.5 million estate for his three daughters, who just happened to be married to three ever-loyal Cornish M.P's. He did the same for exdirector Caswall, and thereby gained the support of the seat at Leominster for the rest of his political career. Others who could not help him were left hanging.

By the end of May, the tumbrels had ceased to roll and it was time to take up the South Sea rescue legislation again. Bankruptcy was not an option, because wiping out the shares that the Government's former creditors had received in the earlier refinancings would amount to a repudiation of the National Debt. The result was a plan to keep the Company alive, while providing some relief to the swindled shareholders by increasing the value of their shares. This was done by adding £2 million to the capital accounts through cancellation of 200,000 treasury shares, voiding the shares not fully paid for, forgiving the Company's obligation to pay the £7.5 million sweetener it still owed the Government, and distributing what remained of the treasury stock ratably among the shareholders. Enforcing collection of the money due on the unpaid subscriptions might have been another way of enhancing the value of the Company's shares, but that this was unthinkable because 138 Members of Parliament were among those who had never paid up.

The outraged shareholders mobbed Parliament with angry denunciations, but Walpole could, or would, do no more, and the reorganization bill finally passed on August 4, 1721. The King gave his assent and dissolved Parliament on August 10, with the news that commercial relations with Spain had been restored through diplomacy on the terms stated in the 1713 Treaty of Utrecht.

The stock market soon returned to normal, and the country began a period of sustained economic growth that was to last for the rest of the Century. The South Sea Company lingered on for the purpose of distributing payments on its holdings of government debt until 1854, when Gladstone converted its remaining assets into the Mid-Victorian Consuls that are so beloved by the characters in Jane Austen's novels. The Consuls were distributed to the shareholders, and the Company was dissolved at last.

Blunt retired to Bath with his small allowance, and vanished from history. Knight escaped from prison with the possible connivance of the British Government, set up business with his son in Paris, and soon was as rich as ever. Ainslabie lived happily ever after among his water gardens at Studly Royal, and now rests under an impressive memorial plaque in Ripon Cathedral. Like some of their modern counterparts, they don't seem to have suffered all that much for their misdeeds. The only good news here is that Gibbon lived long enough to restore his fortune, and thus was able to leave behind enough money to allow his grandson the leisure to write *The Decline and Fall of the Roman Empire.*

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The rise and fall of the South Sea Bubble has engendered much debate on many subjects, including quite a dustup among economic historians over what a bubble really is.[3] But for me, the whole episode is just a dashing good story with all the elements of drama except sex. There was probably some of that somewhere in the story as well, although I couldn't find it. At any rate, I don't think the rather corpulent Duchess of Kendal quite meets the casting requirements for a part in a Fanny Hill-style bodice ripper.

The result was a sudden deflation that temporarily threw the economy back to the days when all transactions were in specie. Over the past 50 years, the public had gotten used to paper money, which then included not only privately-issued banknotes but also bills of exchange, commercial paper and even stock certificates. Suddenly, much of the aggregate money supply was no longer acceptable in payment for obligations, and it became impossible to transfer funds from one part of the country to another, or to purchase goods, or to pay rents, except by the physical delivery of coins. Mercifully, the period of extreme deflation only lasted a few months, but in that brief

[3] See, e.g., Graber, *Famous First Bubbles* (2000); Neal, *Were the Mississippi and South Sea Bubbles Rational?* in *The Rise of Financial Capitalism: International Capital Markets in the Age of Reason* (1990).

period meat was selling at a farthing a pound in Ireland, London coal prices declined even in the face of approaching winter, and landlords suffered as tenants found themselves unable to pay their Michaelmas rents.