

SOUTH SEA BUBBLE – *THE NEW PALGRAVE DICTIONARY OF ECONOMICS, SECOND EDITION*

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Abstract

The South Sea bubble resulted from an equity-for-government debt swap gone wrong, and occurred in England in 1720. Prices of South Sea Company stock rose sharply following the announcement of the scheme, and collapsed eight months later. Together with the Tulipmania (in 17th century Holland) and the Mississippi Bubble in France (in 1719/20), the South Sea bubble is one of three famous “early bubbles”. Frequently cited as an example of investors’ folly, the factors driving the sharp rise and fall have remained controversial. The so-called Bubble Act of 1720, passed before the bubble peaked, restricted the development of a vibrant market in publicly traded companies for a century.

Historical Background

The South Sea Company was founded in 1711, on the expectation that peace between Spain and England after the end of the War of the Spanish Succession would produce profitable trading opportunities with the „South Seas“ (Spanish America). The Company’s trading activity remained intermittent and unprofitable throughout the 1710s. In 1719, a new scheme was launched – the conversion of government debt into equity of the South Sea Company. Debtholders of the 1710 lottery loan were offered the option to convert their holdings into company shares. The government agreed to make interest payments to the company instead of to debtholders. As old (and illiquid) loans were swapped for liquid company shares, debtholders gained. The government negotiated a lower rate of interest, and the South Sea Company made a modest profit. The 1719 equity-for-debt swap is generally seen as Pareto-improving.

The 1720 conversion scheme differed in important ways. Key elements included (i) the absence of a fixed conversion ratio – higher prices of South Sea stock meant that more debt could be bought with each share, (ii) issuance of new stock on installment, with only a small down payment required, (iii) massive lending against shares,

and (iv) a high degree of corruption in the awarding of the contract. The South Sea conversion also shared important characteristics with the John Law’s Mississippi scheme in France, which produced a similar run-up (and crash) of prices half a year earlier.

Both the Bank of England and the South Sea Company competed for the contract to convert government bonds into equity. After bribes to MPs, ministers, and members of the court (of about £ 1.3 mio), the South Sea Company won the right to perform the conversion in March 1720. By this time, the price of its shares had increased to 255, from 128 at the beginning of the year. The share prices of other companies moved up and down in parallel with South Sea stock, but less sharply (figure 1). The company proceeded to issue fresh shares in four subscriptions, and offered to convert debt into shares on (modestly) generous terms. By late June, prices had risen to 765, and forward prices during the summer rose as high as 950. When regular trading resumed, prices began to weaken, but the fourth subscription was still strongly oversubscribed. In September, prices fell quickly. By year-end, they had almost declined to their January level.

Share price of major English companies, 1718-1722

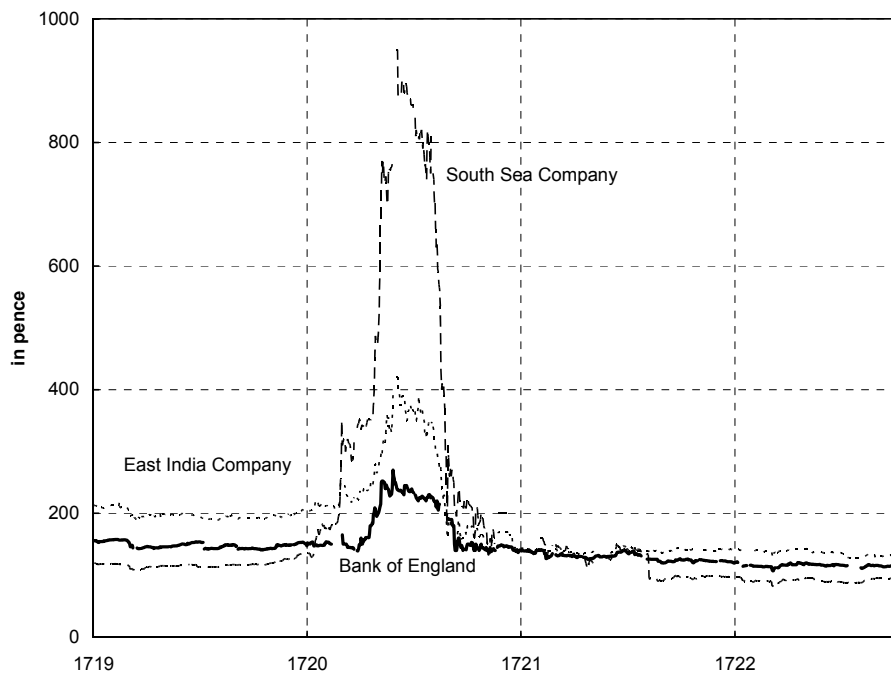


Figure 1

Interpretations

Since Mackay's classic *Extraordinary Popular Delusions and the Madness of Crowds*, the South Sea bubble has often been cited as a prime example of irrational investor behavior. Peter Garber (2000) in contrast argued that the share prices increased in line with "changing view(s) of market fundamentals". If the scheme had succeeded in improving economic conditions in England as a whole (as John Law argued it would), the firm's large capital base might have allowed it to pursue profitable ventures. Yet most of these remained vague, and the company had no track record of successfully making money from anything other than financial transactions. It is doubtful if future profits could ever have been high enough to justify the company's market capitalization in the summer of 1720. Even Garber accepts that prices above 400 are hard to square with reasonable expectations of future profits. Easy credit, investor preferences for lottery-like payoffs (as a result of shares being sold with only a small down payment), and restricted free float (caused by company lending against its own shares) may have contributed to the start of the bubble.

Recent work has focused on the reasons why the bubble, once underway, could expand greatly. Dale (2004) argues that apparent mispricing of subscription receipts proves investor irrationality, while others have argued that the gap can be explained by the option-like nature of receipts. Voth and Temin (2004) examined the trades of a goldsmith bank, Hoare's, which made large profits buying and selling South Sea stock in 1720. They argue that the bank was aware of the overpricing, but invested in South Sea stock regardless. Predictability of investor sentiment made it rational to "ride" the bubble, and to sell out with a profit as soon as it began to deflate. This strategy is similar to hedge fund behavior on Nasdaq in the late 1990s (Brunnermeier and Nagel (2003)). If other large investors faced similar incentives, the lack of a co-ordinated, early attack becomes easier to understand. The role of market microstructure imperfections was probably limited, as opportunities to sell short were abundant. However, the nature of the settlement process and the artificial reductions of free float engineered by the company may have contributed to the bubble.

Consequences

The rise and crash of share prices in 1720 had few direct economic consequences. As prices declined, former debtholders demanded compensation. Parliamentary investigated the scheme in which itself had played such an important role. Directors had most of their assets expropriated. In contrast to the resolution of the Mississippi bubble in France, those who had tendered government bonds for company shares received partial compensation in the form of fresh government debt. The political consequences were possibly more formidable than the immediate economic ones. Leading politicians who had taken bribes, such as the Chancellor of the Exchequer, John Aislable, were forced out of office and incarcerated. Robert Walpole, sometimes referred to as England’s First Prime Minister, distinguished himself both through his opposition to the scheme and competent handling of its fallout. He succeeded Aislable at the Exchequer and remained in power until 1742.

The collapse of the South Sea bubble is sometimes seen as a factor behind the Bubble Act. This appears to be erroneous, as it was passed before the bubble deflated (Carswell 1993). Its passage and rigorous enforcement after the summer of 1720 probably owed more to the company’s efforts to support its own sagging share price. Because of the Act, new equity issues became very rare for almost a century. The Act was only repealed in 1825.

References

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