



LET'S TALK ABOUT...

FINANCIAL LEXICON EDITED BY THE SWISS ASSOCIATION OF ASSET MANAGERS

Bubbles of the XVIII and XIX Centuries

(Part Five) The tulip bulbs' story in Holland, the Mississippi Company in Paris and the South Sea Company in London, all of them having taken place in the XVIII Century, were to be the forerunners of many more speculative events that marked the next century, as new technological discoveries and innovations emerged, sometimes revolutionary ones, being able to catch the attention of both smart and impudent promoters, as well as informed, careful and sometimes naïve investors.

Among the main actors of XIX Century' speculations stand the railways, thanks to their potentials and public appeals, and the fantasies they generated in both technical and financial terms. The railway is for that century what the innovations in information and communication technology, aerospace and biotech are for today's socio-economic scenario. The great railway enterprises were sometimes real and actually implemented on the ground, but some of them never went beyond the state of paper plans or projects on some maps. But in all cases they often stimulated the interest of investors, and projects dazzled them with the prospects of enormous returns. However, within those speculative environments, there were positive results too, as the investment pressures took to the more dense diffusion of lines than more rational plans could have designed. That is particularly the case in the United States and some regions of Great Britain. The rapid diffusion of railways combine with the establishments of banks, first of all in America, where they could be found in any village where some sort of mine, agricultural, industrial or trading activity was present. The speculative feature of pioneer-style banking, all the same present today in banking industry, is the often inadequate relation between the volume of banknotes issued and the underlying gold reserves, as well as the excessive volumes of loans granted without adequate coverages. In such scenario the third major speculative agent was soon to be the real estate, until the popular development of "the mother of all bubble generators", that is the stock exchange came to dominate the field. Property and equity markets were then to become, for the best and the worst, the most relevant binomial in the evolution of financial markets.

(to be continued) - GLT

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(Part Four) In the year 1720 the huge speculative bubble linked to the South Sea Company of London, with its founders Robert Harley, Earl of Oxford, and John Blunt, aimed at softening the Crown's big debt through trading mineral resources and slaves in South America, comes to a climax, that is also the beginning of its end. Many investors had put all their savings in the enterprise, attracted by the promises of strong and quick returns, and the Company's shares were sold off like cakes, while their price continuously increased; but at that point doubts emerge and progressively crack the dominant euphoria, according to any typical bubble pattern. Suffice it to say that while the share's price was about 128 Pounds at the beginning of 1720, it had reached the level of 1000 Pounds just a few months later, so fueling illusions as well as actual gains for those investors who had felt the risk in time and had taken profit accordingly. The speculative spiral had become so giddy that the Government, although a promoter of the enterprise itself, had to issue a specific law, the Bubble Act (being the first time such word was used in a formal document), in order to soften the speculative pressure. Thus emerging doubts, profit taking, the just issued regulation, all generated a lot of panic selling and the market soon collapsed. Due to the spreading emergency the newly-established Bank of England was unsuccessfully invoked as rescuer. The promoters, who had been previously admired as expected savers of the British public finances, were now pointed as responsible of the huge collapse, which had made few persons rich but so many more fully spoiled of their savings. It is worth noting how similar the pattern is for the different stories and how it maintains its main features through different places and times, until today. We may just turn to what is currently happening in China, where a non-primary commodity like garlinc is being bought up aggressively, both in physical terms and through future contracts, so that its price has been multiplied many times in a very short period of time, and more and more investors are being attracted by its potential further appreciation. *(to be continued) - GLT*

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(Part Three) If the most intriguing and cited story of speculative bubble in XVIII Century's France is the one of the Missisipi Company, just in those same years another institution, among the many which had been founded with various goals in the form of the modern equity-sharing corporation, was to become all the same renowned in Britain. The even more exotic-named South Sea Company was established in 1711 with the same purpose as its French sister institution, that is softening the huge national debt. The idea of using a private trading company in order to recover the distressed public finances actually seems to look pretty trendy and appealing in those days on both sides of the Channel. In London the plan is implemented and promoted by two members of the British high society, Robert Harley, Earl of Oxford, and John Blunt, who acted with the Crown's approval. A clarification may be necessary about the company's name, because the term "South Seas" today refers to the vast area of the South Pacific Ocean which includes the numerous and wonderful Polynesian island groups, to be sailed and explored some decades later by Captain Cook and other prominent master mariners. But at the beginning of the XVIII Century the term is instead most often applied to Southern America, a land of fortune through the trades of rich mineral fields and slaves. Harley and Blunt aimed at getting rich returns from those activities, although the territories were under the control of Spain and Britain could only benefit from limited agreements, just allowing few commercial travels and the sharing of the related profits between the two countries. However the two bold gentlemen did not mind about such limits and in promoting the public participation to the enterprise they pointed out to exponentially higher trading volumes and returns than could be reasonably expected, in order to attract huge investments by many people. This time too excess of optimism, euphoric and irrational stances, leverage and savage promotion, all fueled the typical features of speculative bubbles of any times, with the aggravating element of the Crown's collusion. The South Sea Company's shares were issued in larger and larger amounts and reached higher and higher prices, so absorbing the national debt and in just nine years – from 1711 to 1720 – the whole British public debt was weighting on the Company's accounts. It was the opposite situation of the recent financial crisis, when debts and toxic instruments held by private financial institutions have been bailed and rescued through the interventions of governments and central banks. In those days instead the government debt was supposed to be saved – so to say – through the speculative approaches of private corporations and the support of their all the same "toxic" instruments ! And, when the top of the bubble was reached, it was to blow up and the whole project to collapse, according to the usual pattern. *(to be continued) - GLT*

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(Part Two) The Mississippi Company was established in XVIII Century France with the aim of giving coverage and assuring convertibility in gold to the banknotes then issued by the just founded Banque Royale. It was a particularly hard time for the French public finances, immediately after the death of Louis XIV and a long period of costly wars. The Company was supposed to exploit mysterious and undisclosed gold fields in the far-away region of Louisiana: no perspectives had been undertaken and no proofs existed about the presence, not to say the importance, of those fields. However the promotional activities carried out by John Law, both a smart gambler and financial wizard, were highly successful and the Company's shares sold off rapidly among larger and larger groups of investors, excited by the opportunity of easy and quick returns, as is the case in any speculative bubble. Through an efficient secondary market, shares could be re-sold at increasing prices, and the process made further issues possible and allowed a certain repayment of the huge public imbalance. But the gap absent in this mostly virtual process was the real gold to be got from the New World. While the amounts of issues were skyrocketing and so were the shares' prices, during the year 1720 the first doubts emerged and several banknote holders asked for the conversions of their instruments in fine gold. In order to appease the applicants short-term arrivals of great amounts of gold were announced and groups of fancy miners were even shown paradeing in the streets of Paris, as members of a ready-to-leave expedition bound for Louisiana to collect and carry the gold home. But, as Galbraith relates, those same persons were unfortunately seen with very different looks some days after, as they were just street beggars whom John Law had hired for the show. At that point the operation collapsed under the increasing run to exit and panic selling, and due to the state of emergency the obvious solution was to decree the non-convertibility of banknotes in gold. Many savings went burnt and just a small group of promoters got big profits. Unlike other similar situations, here the assumed culprit was pretty easy to identify in John Law, the British scapegoat, although many personalities of the French Court and of the Paris establishment had contributed to fuel the disaster and profiting from it. However John Law escaped, firstly toward Britain and then – how odd – Venice, from where Giacomo Casanova had just flown away, coming to Paris to establish the first modern lottery, so to put money into the poor French treasury. *(to be continued) -GLT*

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(Part One) Besides the tulips' story in XVII Century Holland, other speculative events mark the European financial and economic scenarios; the most cited ones, and often mentioned in modern publications and reviews, involve two old institutions with "exotic" shades: the Mississippi Company and the South Seas Company. The first story is pretty complicated, in mixing public and private interests. It takes place in XVIII Century France, when conditions of the state treasury were very poor, due to the high costs of wars, the lavish expenses of the just died king Louis XIV and the inefficient fiscal apparatus. So, while Messer Giacomo Casanova was charged with the setting of a grand public lottery in order to get some money for the royal treasury, after escaping Venice and his stormy affairs with the wives of high-ranking gentlemen of the Serenissima, just with a similar purpose Mister John Law comes on the Paris stage. Actually Mr Law was a professional gambler, although the scion of a well reputed British family of financial tradition. His aim was the establishment of a new banking institution, able to relieve the huge public debt in some innovative way. And Mr Law, as a real financial wizard, shrewdly smell the opportunity and proposed the setting of a new bank, aimed at issuing money which was not so much granted by gold as usual, but rather property, the best of real assets. However such idea did not meet with the favour of many and, in the spring of 1716, the Banque Generale was founded, soon to be renamed Banque Royale, with the privilege of issuing banknotes convertible in gold. But the royal gold reserves were skimpy indeed, the issues were getting greater and greater and soon the problem arose to find a source of gold in order to properly cover the issued monetary mass. The fervid mind of John Law found a solution through the foundation of a mysterious and exotic-shaded Mississippi Company, for the exploitation of gold deposits in the New World, namely Louisiana. Of course, there were no proofs and no documentations related to such gold fields, neither any perspections were actually undertook. *(to be continued) -GLT*

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