

Bubbles In A Volatile Market  
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The eighteenth century gave rise to one of the greatest achievements in European economics. The stock market grew as a result of the popular joint-stock companies. While the benefits of this system were, and are, numerous, trades based on misinformed opportunism, fear and panic led to episodes of chaos in a volatile market. The history of the early European stock market is riddled with episodes of catastrophe.

The stock market of the time was less than perfect. Taking place primarily in any of the thousands of coffee houses in every city, between amateur share holders, trades were not yet formalized. It was in this “warm, secure fug of smoke, and drink, and chatter,” that entrepreneurs from all types of companies lauded their fledgling companies as the soon-to-be biggest monopoly in history (Balen, 4).

Trades of shares were often based simply on whims, rarely upon knowledge of the company in question. In this type of trading, transactions are often simply uneducated guesses, based on hunches. In these markets, where feelings can override logic, one common problem arises: *bubbles* (Balen, 6).

The term “Bubble” can be most easily defined as a random “outburst of irrationality” (Garber 3). This being said, bubbles are a phenomenon that occurs when a large, usually nationwide, group makes a financial undertaking based primarily on speculation of future profits. Throughout modern European history, there have been three classic bubbles, the Dutch “tulipmania,” the French Mississippi Bubble and the English South Sea Bubble.

In seventeenth century Holland, nothing could be more stylish, or expensive, than a garden full of exotic tulips, or rather, the tulip bulbs. Tulips were first cultivated in Turkey, and introduced in Austria in the 1500’s. Beginning in 1634, a number of “nonprofessionals” became interested in the blossoming tulip market.

Charles Mackay, in the mid nineteenth century, was one of the first modern writers to document “tulipmania.” In his book Extraordinary Popular Delusions & the Madness of Crowds, he reported that during the height of the tulip craze one Semper Augustus tulip bulb was sold for 5500 guilders, the modern day equivalent of \$33,000 (Qtd. Garber, 43). As quickly as the desire for tulips had risen, it fell. Tulips that, days earlier would have fetched a small fortune, were worth next to nothing.

While still puzzling, the dramatic plunge of tulip value can best be attributed to a case of supply versus demand. As more and more people saw the ease with which one could literally grow money, they, more than likely, saturated the market with “common bulbs.” This aside, the tulip bulb is fairly durable, and capable of producing a number of bulbs itself. The number of tulips on the market could double, or more, during the course of a few years (Garber, 46).

Louis XIV’s War of the Spanish Succession had left both France and England swamped by a postwar government debt. Due to the lack of real knowledge about economics at that time neither knew the true potential of large-scale banking. Both governments eventually turned to privately run joint-stock companies, namely England with the South Sea Company and France with the Mississippi. In time, both of these companies would “Bubble” and ‘Burst” (Palmer, 245).

The simplest way to explain the factors that led to the Mississippi and South Sea Bubbles is John Law’s “monetary theory and system.” Law founded an idea “bound in an environment of unemployed recourses.” In this environment, the production of paper money would cause commerce to expand, increasing demand. In order to pay for a large

financial project, an entrepreneur would need to simply promise a future return. The promise would bring financial backing, and, in turn, eventual profit. (Garber, 47)

This system was often used for buyers of stock to get out of debt quickly. The owner would convince a potential buyer that the stock he purchased for one hundred pounds was worth three hundred. This could continue, until the stock was being sold for well over ten times its original price. The problem with this free money system is fear. Eventually, the price became outrageous, and the owner realized that his stock would not sell for his asking price. When he sold for the price he purchased it, other owners took note. They began to become afraid, selling their stocks to minimize loss. Quickly, the stock plummeted to near worthlessness, and the system collapsed, a sad state of affairs that has taken the term “Bubbling.”

Post war France was in an economic bind. Louis had repudiated as much of the internal debt as he could and France’s economy was swamped with debt. Louis raised high taxes, in an attempt to pay off his debtors. With the nobles’ exemption from these taxes, the majority of the burden fell upon the shoulders of the merchants and working class. Louis was open to nearly any solution to his financial crisis. In an attempt to save his country, he turned to the overlooked theories of a Scottish financier and card player, one John Law.

In the summer of 1717, Law, after being permitted by the French Regent, assembled the *Compagnie d’Occident*. This company was established to monopolize the growing trade between fur rich Canada and the pelt hungry open markets of Louisiana, ie. The Mississippi Company (Palmer, 245).

Law took subscriptions to finance the operation, mostly to be paid in government debt. He converted this debt into long-term rentes, a set of loans, payable by the government in a series of regular repayments with a reduction in interest (dictionary.com). Law assumed that once finance was readily available, commercial growth would come naturally.

It appeared that England’s economy, while still showing war’s £50 million strain, was on the rise (Garber, 109). The War of the Spanish Succession had encouraged the production of paper money in Britain. London alone housed 675,000 citizens, all seeking things to buy with that money. It was common for a man “to have made a ‘plum’, as current slang described £100,000” (Carswell, 43). Many of these citizens were buyers of shares of the South Sea Company.

The “moneyed-men” began to stray away from London’s many coffee houses. A series of narrow, inner-city alleyways had recently sprung up as one of the liveliest areas of commerce in the city. Exchange Alley, as it was called, was crowded with traders, barbers, lawyers and insurance clerks, all seeking to sell, secure and finance. One of the companies that was raising a great demand, and garnering the greatest attention, was the newly established South Sea Company

The South Sea Company’s greatest backer was not the public, however. The company paid bribes to leading parliamentary members in order to raise “suggestions” in parliament for possible economic development. In August of 1720, Parliament, not as a whole, but as a collection of buyers, purchased a considerable portion of the South Sea Company’s stocks.

Parliament’s large holding brought many stock buyers to desire stock in the company. It also cemented the company’s holdings in the South Sea. Not only was it

backed by some of the wealthiest men in Britain, no other company had a chance at securing Parliamentary backing, courtesy of the company's bribes. While these bribes are often looked at today as signs of approaching fraud, bribery of officials was a common practice of the time (Erleigh 83).

To pay for the bribes, which totaled somewhere in the area of £1.5 million, the company opened two new subscriptions of shares during April 1721, the first with 22,500 shares, and the second with 15,000. These cost £300 and £400 respectively. These subscriptions allowed a new body of investors to purchase shares that were previously unopened. When the 37,500 shares were purchased quickly, it appeared to the market that shares were in great demand. This caused the stock to bubble, since the shares were bought and sold for increasingly large prices, simply due to the apparent demand.

The Dutch tulip market, French Mississippi Company and British South Sea Company all, in effect, bubbled. The same problem has been speculated for their downfall: fear. When stocks are first introduced in demand and become valuable, a huge market opens for them, what modern stock analysts call a "Bull Market." There is a point, however, when buyers realize that they cannot sell their shares for a profit. The shareholders, one by one, sell their shares for less and less, in order to minimize loss. This often cascades into what is now called a "Bear Market." In this market type, stocks can plummet in weeks or days, often low enough that the companies are forced into bankruptcy. This happened to all three bubbles, which subsequently burst.

When the Mississippi Bubble collapsed, it terrified the French. Law had convinced the government to route a huge portion of its spending into a company that failed to produce. The French were so fearful of a repeat of this catastrophe that they all but cut themselves off from the market, in order to distance themselves from the concept of stocks. The government repudiated much of its debt, forcing many of their debtors into bankruptcy. It would be over a century, well after the French Revolution, before France would once again attempt a market economy.

Britain was hit almost as hard as France. Parliament, however, coped much better than Louis XIV. Instead of disallowing all sales of stock, they introduced the Bubble Act. This act forbade any company, not sanctioned by the government, from selling stocks. These "limited" companies had to get a charter from the government, after proving their reliability.

The Dutch, the first country to experience bubbles, were the least damaged, partly due to their already moderately stable economy. They kept their market system, although a substantial portion of the populace was turned off because of their losses. The Dutch market suffered similar bubbles again, in its history, but none as disastrous as tulipmania.

The problems of bubbles continue to affect the economy today. The modern system of trade is much more refined than its 18th century counterpart. Formalized shares, traded between companies sanctioned by governments and secured by powerful insurance companies shift billions of dollars each day. The market, however, is still far from invulnerable. From the dot com bubbles of the 1990's to the post 9/11 market drop, the market economy continues to suffer from the same problems. As long as there continues to be fear, and idiosyncrasies based on irrationality, there will be bubbles.

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