1 The Three Famous Bubble Episode: Are They "Bubbles" at all?

1.1 Tulipmania, Feb., 1637

It began when a nonfatal virus, known as a mosaic, attacked tulip bulbs. The effect of the virus was to produce a variegated flower of brilliant stripes and colors. The infected bulbs thus became highly prized by collectors and their prices began to rise rapidly.

Futures markets sprang up in local taverns, where trades were made without margin limits. The trading fever apparently spread to common bulbs unaffected by the mosaic virus.

In the first week of February 1637, prices peaked. Then, prices fell dramatically. Peter Garber (2000) estimated that common bulb prices lost about 95 percent of their peak values just three months after the crash. The strikingly colored Semper Augustus bulb, which traded for about $60,000 (in current dollars) in February 1637, commanded just 50 cents in 1739.

The explosive increases in the price of mosaic bulbs can be explained, according to Garber (2000), by supply and demand factors: Rare bulbs were hard to reproduce and in the greatest demand. However, this does not explain the price history of the common bulb, that rose in price twenty-six times in January 1637. Recently, French (2006) argued that the supply of money increased dramatically in 1630s Holland, serving to engender the tulipmania episode.

1.2 The South Sea "Bubble," Aug. 1720

Due to the War of the Spanish Succession (1701-1714), it has left Britain in debt 9.47 million pounds by 1710. In 1710 George Caswall, London merchant, financier, and stock broker, and John Blunt, London scrivener turned stock broker, proposed to the government of Robert Harley that the 9.47 million pounds of outstanding short-term war debts be converted into equity in a new joint-stock company, the South Sea Company. The government's debt would be financed in return for a 6% of interest.

In return, the company was promised a monopoly of all trade to the Spanish colonies in South America (South Seas). The debt conversion was a success. South Sea share prices started at about 120 pounds per 100 pound par value in January 1720.

In June, 1720, the Bubble Act (repealed in 1825) required all joint-stock companies to have a Royal Charter. The South Seas Company has held a charter providing exclusive access to all of Middle and South America. This Act excludes all other competitors of the area. The share price of South Seas finally reached 1000 in early August 1720.

In August the first of the installment payments of the first and second money subscriptions on new issues of South Seas stock were due. A lot of shareholders could not pay for their shares. Probably, this created a liquidity squeeze and generated pressures to sell shares. Furthermore, as news of equity price collapse in Amsterdam (insurance companies) and Paris (Mississippi Company) spreaded to London. The price of South Sea shares started to decline. By the end of September the stock had fallen to 150, triggering bankruptcies amongst those who had bought on credit.

According to Garber (2000), the South Sea Company collapsed due to a weak financial environment (leveraged positions, caused by installment payments and loans on the security of South Sea shares).

1.3 The Mississippi "Bubble," June, 1720

Around 1715 France was bankrupted by wars. It had repudiated part of its debt, forced a reduction in interest payments, and was in arrears on debt service. High taxes depressed economic activity.

The Scottish John Law proposed to solve the government's debt problem and was appointed as Controller General of Finances. In May 1716, Law established the Banque Generale. Equity for the bank came from the sale of stock for both cash and conversion of government debt, the same debt-equity conversion scheme as used in South Sea Company.

French government granted John Law a 25-year monopoly in trades with North America and seigniorage to exchange for the government's war debt obligations.

In 1717, John Law acquired the Mississippi Company to trade with the French colonies in North America, which included much of the Mississippi River basin and the French colony of Louisiana. In 1719 the company acquired the Compagnie des Indes Orientales, the Compagnie de Chine, and other French trading companies and became the Compagnie des Indes.

In 1720 it acquired the Banque Royale, which was founded by John Law as Banque Generale in 1716 (where Law first devised the use of redeemable paper money). Its banknotes later acquired the status of legal tender.

The activities of John Law were financed with share issues. The Compagnie des Indes share price was around 500 livres in May 1719. Law bragged the wealth of Louisiana and its potential profits, which led to a rapid rise on its price of shares in 1719. Shares rose from 500 to nearly 10,000 livres in February 1720.

In May 1720 the Compagnie share price was considered too high at a fixed price and a proposal was launched to reduce the price from 9000 to 5000 livres. Furthermore, Banque Royale notes would also be reduced in value to 50% of their face value. Following public protests, these plans were revoked on 27 May and the bank notes restored to their original value. However, on the same day the Banque Royale stopped payment in specie. Confidence in the value of Compagnie shares and particularly paper money was completely destroyed. The share price dropped drastically, and declined to 500 livres in September 1721. By the end of 1720 the Regent Philippe II of Orleans dismissed Law, who then fled from France.

According to Garber (2000), the fundamentals of the Compagnie des Indes is quite robust. The only major problem was the failed monetary experiment (issuing paper money and fixing the price of his shares) which generated a short period of unsustainable hyperinflation.

Garber, Peter M. (2000), Famous First Bubbles: The Fundamentals of Early Manias. Cambridge Massachusetts: The MIT Press.

Kindleberger, Charles P. (1996), Manias, Panics, and Crashes: A History of Financial Crisis. New York: John Wiley and Sons.