Writing the History of the Financial Crisis: Lessons from the South Sea Bubble

*Patrick Walsh**

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School of History and Archives

University College Dublin

*Dr Patrick Walsh is an IRCHSS CARA Postdoctoral Research Fellow jointly attached to the Dept. of History, University College London, and the School of History and Archives, University College Dublin, email: Patrick.A.Walsh@ucd.ie. He is currently completing a book on Ireland and the South Sea Bubble to be published by Boydell & Brewer in 2013.

'Financial crisis: That hardy perennial' - Charles Kindleberger (1978)

Abstract:

The ongoing global financial crisis has from its beginnings in 2007 fascinated observers who have struggled to contextualize and understand it. Overwhelmed by the apparent scale of the crisis, and its seeming never-ending state, many commentators have preferred to regard it as an unprecedented occurrence without parallel. Such an approach has had its attractions for politicians and policy makers who either didn't see the crisis coming, or who refused to acknowledge the warning signs. This paper argues, however, that the current crisis, while perhaps different in scale and scope, is not quite as unprecedented as we might like to imagine. Instead this paper looks at the history and histories of financial crises going back to the first modern crises in the eighteenth century. It examines how people have written about crises in the past, and looks at the lessons that studies of past crashes might offer at the present time. Particular focus is paid to the story of the South Sea Bubble of 1720, the first great stockmarket crash in these islands. This paper draws on my ongoing research into the Irish dimensions of that crisis, while also drawing on research by contemporary economists, literary scholars and historians showing how an interdisciplinary approach can help to tease out the mysteries of past crises, while also offering potential enlightenment for the future.

In September 2007 Britain witnessed its first bank run since the mid-nineteenth century. Customers flocked to their local branch of the Northern Rock bank to withdraw their savings as rumours spread about the bank's viability. This was a seismic moment; it marked one of the beginnings of the current global economic crisis, and showed how seemingly abstract news stories about financial markets could affect the ordinary man or woman on the street. Facing the twin threats of market and consumer panic the British government was forced to nationalize Northern Rock. Over the next number of months Gordon Brown's government earned plaudits for their apparently decisive handing of the crisis, leading to Brown's famous declaration that he had saved the world.[1] This slip of the tongue

[1] Gordon Brown speaking in the House of Commons, 10 Dec. 2008 (*Hansard 6 (Commons),* vol. 485 col. 527). See also *The Guardian,* 11 Dec. 2008.

looked even sillier in Autumn 2008 when the financial crisis went truly global. In America the seemingly sudden collapse of Lehman Brothers, coupled with the colossal restructuring of AIG, Bear Stearns and those two venerable relics of the New Deal, Freddie May and Fannie Mac, ushered in a period of financial uncertainty and changed the parameters of the then ongoing presidential election. Meanwhile in Ireland things were also moving fast. In January 2007 Anglo-Irish Bank had been described in an influential report as the best bank in the world.[2] Just over eighteenth months later the same bank faced ruin as its share price plummeted and investors fled. The immediate cause was the turbulent state of the global markets, and the bank's over-exposure in the collapsing property market. As time went on, it would also become clear that Anglo's corporate governance structures were not what they should have been.[3] In September 2008 the Irish government faced with concerns about the viability of the banking system, and perhaps mistakenly viewing Anglo Irish Bank as an integral part of the system (it was after all predominantly a commercial and business rather than a retail bank) introduced the now famous bank guarantee. By the end of 2008 the government also owned a majority stake in Anglo having effectively nationalized the bank.

All of the above should be familiar to most readers of this paper. The story of the global financial crisis and the individual stories about the rise and fall of banks like Northern Rock, Anglo, the Royal Bank of Scotland, and Lehmann Brothers amongst others were, however, particularly familiar to financial historians across the world. What was happening before our eyes was something that scholars of historic bubbles and crises recognized. There were clear similarities between the current situation and historic episodes like the Mississippi and South Sea bubbles of 1719-20, the railway manias of nineteenth century Britain, and the 1929 Wall Street crash amongst other events. My particular interest was, and is, on the impact of the South Sea crash in 1720 on the peripheries of the

[2] Oliver Wyman Financial Consultants gave this accolade to the bank on the eve of the Davos Global Economic Forum in January 2007. See *Irish Times,* 26 Jan. 2007.
[3] The best account of the rise and fall of Anglo Irish Bank is Simon Carswell, *Anglo republic: Inside the bank that broke Ireland* (Dublin, 2011).

British state, with a particular focus on Ireland, but also Scotland.[4] In October 1720 the collapse of the London stock exchange and the dramatic fall in the value of shares in the South Sea Company had led to runs on the banks in Dublin and Edinburgh. This was an early case of financial contagion, and demonstrated the potential for events at the centre, in this London, to have ripple effects on the periphery. In 1720 these runs on local banks were halted through the influence of local political and financial elites. Despite this damage was done to the local economies and financial systems. Questions began to be raised about the innovative forms of banking and finance that had developed over the previous three decades such as the expansion of the stock market, the ubiquity of 'paper' money, the development of a national debt, and the emergence of new forms of short-term credit instruments. Some historians have described these developments as the 'rise of financial capitalism' while other scholars have seen them as constituting a 'financial revolution'.[5] The current crisis has sparked some of the same questions, while its gestation has echoes in the rise of previous booms and busts. This paper seeks to explore how historians have dealt with past economic and financial crises, and whether it is possible to learn any lessons from them. Particular reference will be made to my own research on Ireland and the South Sea Bubble noting the resonances between the situation then when Ireland was as now a peripheral economy at edge of a global economic power, then the nascent British Empire, now the European Union.

As the financial crisis developed in 2007 and 2008 the ubiquity of references to past crises seemed interesting and important. The South Sea bubble was everywhere. William Hogarth's famous satirical print was regularly reproduced in newspapers acting as a convenient prop or shorthand description of the

[4] This research project entitled 'The bubble on the periphery: Ireland and the South Sea bubble' was funded by a two year postdoctoral award from the Irish Research Council for the Humanities and Social Sciences. See Patrick Walsh, 'The South Sea bubble: A parable for our time' in *History Ireland*, xvii, 2 (2009); and Patrick Walsh, 'The bubble on the periphery: Scotland and the South Sea bubble', in *Scottish Historical Review*, xci, 231 (2012): 106-124, as well as my forthcoming book-length study.

[5] Larry Neal, *The rise of financial capitalism: International capital markets in the age of reason* (Cambridge, 1990); P.G.M. Dickson, *The financial revolution in England: A study of the development of public credit, 1688-1756* (London, 1967);Christopher Fauske and Ivar McGrath, *Money, power and print: Interdisciplinary studies on the financial revolution in the British Isles* (Newark, 2008).

ongoing crisis.[6] Meanwhile in Ireland Jonathan Swift's poems *The Bubble* and *The Ruin of the Bankers* were regularly quoted. The first of these has been described as one of the most important contributions to the formation of the popular conception of the bubble, and has been regularly reprinted since its first publication in January 1721.[7] Lines such as these castigating the South Sea Company directors have been especially popular:

But I affirm, 'tis false in Fact,
Directors better know their Tools
We see the Nation's Credit crackt
Each Knave have made a Thousand Fools[8]

The Ruin of The Bankers, however, has a particular Irish attraction. Written in the aftermath of the bubble and the run on the Dublin banks, which followed the bubble, it allowed Swift to express, at his vituperative best, his disdain for the new financial classes and their mysterious ways, something he would return to famously in *Gulliver's Travels*, published just four years later.[9] Lines such as the following appealed to contemporaries in 1720 and 2008 in equal measure:

The bold encroaches on the deep
Gain by degrees huge tracts of land
Till Neptune with one general sweep
Turns all again to barren strand

The Multitude's Capricious pranks
Are said to represent the Seas

[6] William Hogarth, *The South Sea scheme*, c.1721. It was most recently reproduced in *The Guardian,* 10 Nov. 2011. It also appeared in the *Financial Times* on 1 Nov. 2008. For a detailed analysis of the South Sea bubble by the media see Julian Hoppit 'The myths of the South Sea bubble' in *Transactions of the Royal Historical Society, Sixth series,*xii (2002), p. 141.
[7]Pat Rogers, 'Plunging in the southern waves: Swift's poem on the bubble' in *The Yearbook of English Studies*, xviii (1988), p. 41. See also, Hoppit, 'The myths of the South Sea bubble', pp 159-62.
[8] Jonathan Swift, *The poems of Jonathan Swift,* ed. Harold Williams (3 vols, Oxford, 1937), I, 248-59.
[9] J.A. Downie, *To Settle the Succession of the State: Literature and politics, 1678-1750* (London, 1994), pp 98-9. See also Chris Fauske, 'Misunderstanding what Swift misunderstood, or the economy of a province' in McGrath &Fauske (eds), *Money, power, and print*, p. 135.

Breaking the Bankers and the Banks
Resume their own when e'er they please

Money, the life-blood of the nation,
Corrupts and stagnates in the veins
Unless a proper circulation
Its motion and its heat maintains[10]

These lines have a timeless quality, the last three lines in the first stanza could act as a commentary on the transformation from 'development opportunities' to 'ghost estates' that characterizes part of early twenty-first century Ireland. Swift's other lines on bankers were also popularized with one correspondent to *The Irish Times* highlighting a later attack on bankers and suggesting its contemporary resonances: "I have sometimes thought, that this Paradox of the Kingdom growing Rich, is chiefly owing to those worthy Gentlemen the BANKERS, who . . . are the only thriving People among us: And I have often wished that a Law were enacted to hang up half a dozen Bankers every year, and thereby interpose at least some short Delay, to the further Ruin of Ireland".[11]

These reappearances of older critiques of bankers and speculators in the contemporary media demonstrated that the current crisis was not a totally new phenomenon. They also suggested that there was a wider cultural memory from which appropriate examples could be drawn upon. In America this could be seen in the musical output of Bruce Springsteen amongst others, while the return to prominence of Pete Seeger in 2008, and indeed the calls for Nobel-level recognition of his contributions to progressive societal change suggested something was afoot there too.[12] Such digressions aside it is clear that attempts

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[10] Swift, *Poems,* I, 238-241. For a valuable discussion of these poems see Sean D. Moore, *Swift, the book and the Irish financial revolution: satire and sovereignty in colonial Ireland* (Baltimore, 2010), pp70-74.
[11] Letter to *The Irish Times*, 31 Mar. 2010. This quotation is taken from Swift's 'A short view of the state of Ireland' (Dublin, 1727). For another recent appropriation of Swift as a voice on the current crisis see Jonathan Jacobs, 'Jonathan Swift: Icon of 2011?' in *Ceasefire Magazine* (2011) (www.ceasefiremagazine.co.uk/jonathan-swift-icon-2011: Accessed 9 Mar. 2012).
[12] See Springsteen's, *We shall overcome: The Seeger sessions* (2006). For calls for Seeger to receive the Nobel Peace Prize see *Irish Times* 2 May 2009.

were being made to make sense of the crisis, and that there was an appetite for them. This could be seen the multiplicity of books that appeared analyzing in great detail, and often with Swiftian scorn, the crisis whether at a global or local level.[13] The thrust of some of this work was firmly focused on the historical dimension, and it is on this type of analysis I wish to focus. Was this a case of history repeating itself, were their lessons that could be learnt? Could inspiration and solutions be found in the past to help us get out of this mess? These were some of the questions that came up again and again in this literature.

These were not, of course, new thoughts. Every major financial crisis had seen an increase in scholarship and publishing activity reflecting upon previous crises. Even during the South Sea Bubble in 1720, prints were produced in London and Amsterdam (the two centres of the emerging financial capitalism) depicting the Dutch tulipmania of the 1630s, one of the more bizarre episodes in the history of financial speculation.[14] Both of these episodes, along with the 1719 Parisian Mississippi Bubble would form key parts of Charles Mackay's celebrated *Extraordinary Popular Delusions and the Madness of Crowds*, which was published at the height of the British railway mania in the 1840s.[15] Mackay's work has never been out of print, and has had a disproportionate influence on the historiography of financial bubbles and speculation leading to the perpetuation of many myths that have limited basis in historical fact.[16] His work and others reappeared in the aftermath of the Wall Street Crash which itself sparked a vast literature, both on the technicalities of the crash, and on the wider social impact.[17] The dark days of the 1980s, and the dot-com bubble in the late 1990s would see further publication booms within this genre of economic crash

[13]There are too many to do justice to them here, but notable examples might include Fintan O'Toole's *Ship of fools: How stupidity and corruption sank the Celtic Tiger* (Dublin, 2009) and John Lanchester's *Whoops! Why everyone owes everyone and no one can pay* (London, 2010).
[14] Anne Goldgar, *Tulipmania: Money, honor, and knowledge in the Dutch golden age* (Chicago, 2007), pp. 306-09.
[15] For mid-nineteenth debates about the 'sins of speculation' see James Taylor, *Creating capitalism: Joint stock enterprise in British politics and culture, 1800-1870* (Woodbridge, 2006), pp 53-95.
[16]Charles Mackay, *Extraordinary popular delusions and the madness of crowds* (London, 1841). For Mackay's enduring influence see Peter M. Garber, *Famous first bubbles: The fundamentals of early manias* (Massachusetts, 2001), pp127-29.
[17] For a superb cultural history of the depression and the writings it inspired see Morris Dickstein, *Dancing in the dark: A cultural history of the great depression* (New York, 2010).

literature, with works like Edward Chancellor's *Devil take the Hindmost* gaining a wide readership.[18] Indeed the first chapter of one frequently updated classic work, Charles Kindleberger's *Manias, panics and crashes*, is entitled 'Financial crisis: a hardy perennial', something which suggests, perhaps gloomily, the continuing utility of the book.[19] The current crisis has seen perhaps an even greater proliferation of literature written with the aim of making the complex understandable, and sometimes with the hope of providing guidance for the future so past mistakes cannot be repeated.

Such sentiments have long lay behind some of the more important contributions to the history of economic crises. John Kenneth Galbraith's seminal study of the Great Depression, *The Great Crash* was written in the 1950s with the explicit goal of educating his readership about the causes of the crash twenty-five years earlier, so that events would not be repeated.[20] Other works like Paul Krugman's *The Return of Depression Economics* and Robert Shiller's *Irrational Exuberance* were written at the height of the early twenty-first century boom, and were intended as warnings.[21] Like some Irish commentators their words were shunned and instead they became veritable Cassandras, with Shiller's commentary on the frosty reception he received on his first book-tour particularly telling regarding the impact of the 'herd' effect. Prospective readers refused to believe in any possibility of a downturn, or in his words: 'Some kind of collective conclusion had been reached about the stock market – and it had a powerful hold on people's minds'.[22] Many of Krugman and Shiller's critics have since renounced some of their original opinions and have gone on to devour important studies like Niall Ferguson's *Ascent of Money* and Reinhart and Rogoff's *This Time will be Different: Eight Centuries of Financial Folly*.[23] These

[18] Edward Chancellor, *Devil take the hindmost: A history of financial speculation* (London, 1999).
[19] Charles P. Kindleberger and Robert Z. Aliber, *Manias, panics and crashes: A history of financial crises* (5th ed. Basingstoke, 2005), pp1-20. Previous issues editions appeared in 1978, 1989, 1996, &2000, and no doubt an updated edition is planned.
[20] J.K. Galbraith, *The great crash, 1929* (New York, 1954), p. 10.
[21] Paul Krugman, *The return of depression economics* (New York, 1999); Robert Shiller, *Irrational exuberance* (Princeton, 2000).
[22] Robert Shiller, *Irrational exuberance* (2nd. Ed., Princeton, 2005), p. xii.
[23] Niall Ferguson, The ascent of money: A financial history of the world (London, 2008); Carmen M. Reinhart and Kenneth S. Rogoff *This time will be different: Eight centuries of financial folly* (Princeton, 2009).

works have sought to place the current crisis in a long-term perspective, with *This Time will be Different* being particularly ambitious in its chronological scope. These works have been hugely popular but have the lessons from them been learnt; will the next time really be different?

It is hard to answer such questions, still less to answer questions about the contribution of historic analysis to resolving the current crisis. There have been some signs that the insights of history are been considered. In America Ben Bernanke, who made his academic reputation as a world-class economist on the back of a study of the great depression, was appointed Chairman of the Federal Reserve, at the outset of the crisis.[24] His appointment can be seen as conforming to the American narrative of the crisis, which has rightly stressed the parallels with the 1930s. Such parallels while not perfect do at least suggest an understanding of the gravity of the situation and the need for radical thinking and solutions, although a new New Deal still seems somewhat of a utopian ideal. In Europe insights from history have, however, been less prevalent in the official discourse. This is unfortunate especially when one considers the current seemingly never-ending deliberations over the possibility of a Greek default. A cursory look at the default rate in Greece over the last 150 years, a period in which it has defaulted more than any other European country might offer some important insights to those involved in the decision-making processes.[25] An awareness of such historical precedents might of course have been useful when Greek admission to the Eurozone was first under discussion. Similarly the current European vogue for austerity at any cost might be contrasted with the American experience under the New Deal, or the beginnings of the European economic miracle in the 1950s, periods, which saw shifts from austerity to expansionist policies. This is an area where recent historical studies, including for example David Kynaston's work on what he and others have termed *Austerity Britain,* might provide some cautionary tales, as well as options for the future.[26]

[24] In 2009 he was named *Time* Magazine's 'Man of the year'. In the accompanying article stress was put on his background as a scholar of the Federal Reserve during the great depression *Time Magazine,* 16 Dec. 2009.
[25] Reinhart & Rogoff, *This time will be different,* pp 98-99.
[26] David Kynaston, *Austerity Britain, 1945-51*(London, 2007).

The focus in his work, and in other studies of post-war Europe, on the development of the welfare state despite the dire economic situation demonstrates the possibilities of alternative policies, and what can be done even at times of crisis if there is a political will to do it.[27] Such histories point to the potential of economic crises as catalysts for change a dimension sometimes lost in the analysis of what went wrong. Nevertheless it is important to understand the causes as well as the results.

The need for cautionary tales has been continuously repeated since Adam Anderson wrote the first history of the South Sea Bubble in the 1760s.[28] Cynics, unfortunately rather missing the point, might see such calls to heed the lessons of history, as expressions of self-interest from the producers of such tales. Knowledge of past experiences and past events may not prevent repeat performances, but at least if should ensure that these repeat performances are informed ones, and are therefore less excusable. These lessons need not go back far in time, and indeed good arguments can be made for the lack of applicability of long-term historical analysis in the computer age. Niall Ferguson, who has done more to bring financial history into the mainstream than anyone else, has drawn attention to the remarkably short careers of top-level City bankers and the subsequent lack of institutional memory available when the next crisis hits.[29] This he argues, and others have made the same point in Ireland and elsewhere, only serves to point to the utility of financial history. Other commentators have highlighted the increasingly diverging languages used by stock-market traders and the so-called 'quants' who develop the complicated mathematical formulas which underpin today's stock-markets. Incomplete understanding of the model didn't matter so much while stock prices were rising but now when they are falling it certainly does.[30] This is an area, however, where historical examples from the distant past might help to illuminate matters. The narratives of previous crashes, most notably the Mississippi Bubble of 1719 and the South Sea

[27] On this point see Tony Judt's *Ill fares the land* (London, 2010).
[28] Adam Anderson, *A historical and chronological deduction of the origins of commerce* (3 vols, London, 1764).
[29] Ferguson, *Ascent of Money,* p. 340.
[30] Lanchester, *Whoops*!, p. 41

Bubble of the following year, are replete with the problems of relying upon new models, which promise great rewards even while their mechanisms are shrouded in mystery.[31] The stories of both of these crashes, are also only fully understandable when the role of individual agency is considered as part of the equation, a crucial and potentially chaotic element too often left out of the mathematical models, which dominate today's markets.

This dimension, the role of the individual and their experiences, is one of the major focuses in my own research. Much scholarly analysis of historic financial markets has been driven by contemporary debates about the origins of modern capitalism and has by design focused on the impersonal and the aggregate. It is possible and even sometimes desirable to move away from the aggregate and instead focus on the choices made by individuals and their consequences. This approach is not without its critics has scope to widen our understanding not just of the South Sea Bubble and the financial world of early eighteenth-century Dublin and London, but also of the experiences of modern day investors caught up in speculative markets, whether in property, shares, or whatever else. Exploring the correspondence of the men and women who bought into the South Sea Company's projects for imperial expansion and debt conversion, and looking at their motives for investing in the company, offers one way into this world.[32] Before proceeding to consider this research more fully, it is perhaps worth outlining briefly the history of the South Sea Company and the bubble of 1720.

The South Sea Company was established in 1711. From its foundation it was intended to pursue multiple objectives. These included an important trading role; the company was given a monopoly on British trade with the Spanish

[31] See Antoin Murphy's study of John Law, the misunderstood genius behind the Mississippi Scheme, which convulsed France in 1719, *The genesis of macroeconomics: New ideas from Sir William Petty to Henry Thornton* (Oxford, 2009), pp 43-72. Also useful here is Anne Murphy's *The Origins of English financial markets: Investment and speculation before the South Sea bubble* (Cambridge, 2009).

[32] This is the approach I take in my own research as demonstrated in Walsh, 'The bubble on the periphery', passim. For a similar approach see Anne Laurence, 'The emergence of a private clientèle for banks in the early eighteenth century: Hoare's Bank and some women customers', *Economic History Review* lxi, no. 3 (2008), pp565-86; and Anne Laurence 'Women investors, 'That Nasty South Sea Affair' and the rage to speculate in early eighteenth-century England' in *Accounting, Business & Financial History*, xvi, 2 (2006), pp 245-64.

colonies in South America. This trading role was never as profitable as the Company hoped it would be due to a number of complex geopolitical factors, which are not pertinent to the present paper. The Company's second function was slightly more shadowy; it was to operate as a financial instrument providing funds to the government. In return for its initial trading charter the Company had taken over large portions of the debt caused by Britain's military engagements in the continent during the previous two decades. (This was not a new innovation; in the 1690s the Bank of England was established for the same purpose.) Despite their modest trading gains the South Sea Company continued to convince the political and investing public that its prospects were good, and as a result it took on more and more of the national debt holding £11.7 millionby 1719. In early 1720 the Company's directors came with ever more ambitious debt conversion proposals backed by promises of even richer trading gains. This led them into a competitive bidding war with the Bank of England, over which corporation would assume more of the national debt. After an expertly managed parliamentary lobbying campaign, which may or may not have involved extensive bribery and false promises, the Company was victorious and assumed an even greater share of the national debt –they now held £43.2 million. This new hegemony led to a sharp rise in the Company's share price despite continuing doubts about the true extent of its trading activities. The share price had risen from £128 in January 1720 to £330 in March, and it would continue to rise.[33]

The next four months would see the Company's share piece rise dramatically reaching a peak of £1050 in late June, before it collapsed almost as quickly as it rose finally crashing in October 1720. The crash came as investors began to realize that the Company was built on poor foundations, or in modern parlance that its fundamentals were 'unsound'. This was made clear by the Director's increasingly desperate attempts to manipulate the markets, while at the same time converting their own shares into property and other more tangible forms of wealth. This stunning rise and fall of the Company's share price has become

[33] For the history of the Company see John Carswell, The South Sea bubble (London 1960) and Helen J. Paul, *The South Sea bubble: An economic history of its origins and consequences* (London, 2010).

known as the South Sea Bubble, and it preoccupied contemporaries at least as much as the legions of later historians who have followed them. Great fortunes were won and lost, rival often ephemeral companies were established, and knowledge, both real and imagined, of the stock market abounded. The possibility of spectacular gains combined with the Company's excellent propaganda machine ensured that the Company's reach extended far beyond the city of London, the traditional source of investors in the great joint-stock companies.

A lot of this research has at first glance some contemporary echoes, though it would be dangerous to push these too far. Nevertheless it is possible to glean some ideas about how people in the past experienced and reacted to a major financial crisis. Individual experiences – how investors learned about the stock market, what sort of information was available to them, how they carried out their investments, how much were investors influenced by others, and how they reacted to changes in market conditions are all important questions to consider.[34] They can help us build up a nuanced and interesting picture of investment during the bubble and the impact of the rising bubble and then the crash on the Irish economy, which has often been seen as a metropolitan crisis. Their experiences were different from ours now but there are still things we can learn, not the least of which is that past crises happened to real people too. Understanding the human impact allows us not just to empathise with past generations, but also to be mindful of the human consequences of present crises. It shows us that neither the South Sea Bubble nor indeed the Great Depression can be reduced to illustrative models, and that therefore decisions about the current crisis need to also take into account the human dimension. This is part of what we need to remember long after the salutary lessons about short-selling, debt for equity conversion schemes, and boardroom neglect have been forgotten. Only then will the next time be different.

[34] See Walsh, 'The bubble on the periphery', pp 110-11 on ho investor networks worked.