

The First Crash: Lessons from the South Sea Bubble. *By Richard Dale*. Princeton: Princeton University Press, 2004. viii + 198 pp. Illustrations, tables, glossary, bibliography, notes, index. Cloth, \$29.95. ISBN: 0-691-11971-6.

Reviewed by Richard Sylla

The South Sea Bubble of 1720 was the mother of all financial bubbles and probably the first of many modern-era international financial crises. Its impact is magnified if we broaden it, as Richard Dale does in this engaging book, to include not only the English events but also the closely related collapse in 1720 of John Law's Mississippi Bubble in France. In each country, bubble promoters engaged in profitable patriotism. They hoped to lighten the burdens of debt that England and France had run up—mostly in fighting wars against each other—by converting public debts into shares of private companies: the South Sea Company in England and the Mississippi Company in France. That was the patriotism. The promoters' profits would come from puffing up the costs of the shares and unloading them at high prices. In a few months of frenzied trading backed by substantial money and credit creation, Mississippi Company shares rose to twenty times par value and South Sea shares climbed to ten times par. The French bubble collapsed in the spring of 1720, and the English bubble was deflated late in the summer as share prices tumbled in short order back toward par.

Dale's particular purpose is to contribute to, perhaps even to settle, a lively current debate among financial economists and historians on the issue of whether investors and financial markets are always rational or are now and then subject to fits of maniacal irrationality. In the debate, proponents of efficient markets and investor rationality claim that there are no bubbles at all, that information available to investors rationally drove prices up, and that new information later rationally drove down prices. At the other extreme, proponents of irrational bubbles—of investor and market irrationality—take the extreme upward and downward price movements of so-called bubbles as evidence per se of irrationality. In between are those who argue for rational bubbles, adopting more of a micro- than a

macroeconomic concept. They contend that some investors for some period of time as a bubble inflates will rationally invest in assets they know to be overpriced, because they anticipate that profits can be made as less rational investors drive the prices of the assets even higher. Wall Street pros call this rational-bubble strategy “momentum trading.”

Dale offers two pieces of evidence to indicate that the South Sea Bubble was indeed an irrational bubble. One was the warning to investors by Archibald Hutcheson, a prominent and respected member of Parliament, that the potential profits of the South Sea Company could in no way justify the prices that were being paid for its shares. On nine occasions during 1720, Hutcheson studied and published, using the techniques of modern securities analysts, detailed reports concluding that South Sea shares were grossly overvalued and would likely collapse. On balance, investors ignored Hutcheson’s cogent analyses as prices continued to rise. Thus it was not the case that they lacked information to make informed decisions.

Hutcheson’s work has been known for a long time. Dale’s contribution is to give it the detailed attention it deserves in the context of the bubble. His second piece of evidence in support of the argument for investor and market irrationality is more original. Dale performs his own Hutcheson-like analysis of the pricing of several “subscriptions,” that is, rights to purchase South Sea shares that were issued to investors who made partial payments for shares on the installment plan. Dale compares prices of these near-perfect substitutes for shares with the actual prices of shares. He finds that most of the subscriptions were overpriced in relation to South Sea shares, which were themselves overpriced. Even more telling is that the various subscriptions were also incorrectly priced relative to one another. For some months investors paid high prices for claims to South Sea shares when they could have purchased equivalent claims for less.

Summarizing the evidence, Dale says, “The only conclusion to be drawn from these valuation anomalies is that, during the Bubble year, the behavior of South Sea investors became manic and irrational in a way that is difficult if not impossible to reconcile with modern finance theory” (p. 171). But the bubble may

have had its rational aspects for some momentum traders. In a recent article, “Riding the South Sea Bubble,” published in the *American Economic Review* in December 2004, which Dale cites as a working paper, Peter Temin and Hans-Joachim Voth show that a London bank made handsome profits trading South Sea shares it knew were overpriced, and—always the tricky part—sold them before the collapse got too far underway.

Although Dale views his main contribution as demonstrating that investors and markets can be irrational, he in fact delivers a lot more. The book has a fine account of what securities markets were like three centuries ago. Dale also demonstrates the connections of the South Sea and French (John Law’s) bubbles. Law probably got the idea for his conversion of French public debt into Mississippi Company shares from the South Sea Company’s small-scale conversion of English debt into shares when it was founded in 1711. Then Law’s vastly larger debt-for-equity conversion scheme in France in 1719–20 probably provided both a model for the South Sea promoters and an incentive for the English state to back them in 1720.

Curiously, Dale argues that the South Sea Bubble “had little lasting impact on the British economy” (p. 178), but he nevertheless considers it important to us now, because investor irrationality can result in resource misallocation, excess business capacity, and other dislocations when bubbles deflate. He cites the 1980s bubble in Japan and the 1990s bubble in the United States as evidence for this view. Perhaps the damage resulting from financial bubbles is more evident the closer we are to them. Others argue, contrary to Dale, that the Bubble Act passed at the height of the 1720 mania, and not repealed until 1825, retarded corporate and equity-market development in England for a century.

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