Trakya Üniversitesi Sosyal Bilimler Dergisi
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ADAM SMITH'İN EKONOMİK KRİZ GÖRÜŞÜ: SOUTH SEA BALONU

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ÖZET

Kapitalist gelişim sürecinde, en çok tartışılan konuların başında ekonomik kriz olgusu gelmektedir. Bu bağlamda, ekonomi literatüründe krizleri açıklamaya yönelik birbirinden farklı birçok görüş ortaya atılmıştır. Kapitalist sistemin bugünkü geldiği aşamada, finans piyasalarındaki gelişmeyle birlikte, daha kompleks finansal ve ekonomik yapı altında, krizlerin bulaşma etkisini hızlandıran uluslararası bir yapılanma söz konusudur. Günümüzdeki krizlerle geçmiş dönemlerdeki ekonomik krizler arasında bağlantı kurmamızı sağlayan temel noktalardan biride balon oluşumudur. 18. yüzyılın ilk çeyreğinde, İngiltere'de görülen South Sea Company balonu ve çöken finansal sisteme müdahaleye yönelik; 1720 yılında yayımlanan "Balon Yasası" araştırma kapsamında mercek altına alınacaktır. Ekonomi biliminin kurucusu kabul edilen Adam Smith'in bu olaya yaklaşımı da bir hayli dikkat çekicidir. Çalışmamızda, liberal ekonomik sistemde yaşanan bunalımlar gölgesinde gelişen olaylar ekseninde, Adam Smith çağına yakın örnek olay olarak alınan "South Sea Bubble" hakkındaki tartışmaların nasıl yorumlanması gerektiği tartışılacaktır. Böylelikle Adam Smith'in ekonomi yaklaşımıyla, ekonomik krizler hakkında edinilecek tarihsel bakış açısı, çeşitli çözüm önerilerinin oluşumuna katkı sağlayacaktır.

Anahtar Kelimeler: *Adam Smith, Ekonomik Krizler, Balon Ekonomisi, South Sea Balonu.*

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ADAM SMITH'S VIEW ON ECONOMIC CRISIS: SOUTH SEA BUBBLE CASE

ABSTRACT

Economic crisis issue is the leading among argued subjects in the capitalist development period. In this sense, there had been numerously different opinions emerged to interpret the crisis in the economics literature. Modern international economics and finance structure of the world is accelerating the contagion of the crisis with the improvements due to the recent capitalist system comprehensions. In addition, formation of bubbles is constructing the main relationship between current financial crises and the other historical economic depressions. The study discusses The Bubble Act regulations issued in the first quarter of 18th Century in the year of 1720 to intervene the financial system of United Kingdom (UK) for The South Sea Company bubble. Commonly respected founder of the economics discipline Adam Smiths' approach to the mentioned incident is also quite noteworthy. Our study analyzes the concerns for the sample of "South Sea Bubble" case throughout the Adam Smith era under the circumstances of liberal economic system depressions. In this way, the scope outs for economic crisis would be determined by the historical understanding of Adam Smith's economics approaches as well.

Keywords: *Adam Smith, Economic Crisis, Bubble Economics, South Sea Bubble.*

1. INTRODUCTION

The Europe oriented market and trade concept had formed between the 15th and 18th centuries. Mercantilist system had been adapted with respect to overseas trade boom. In that order, political economics theories were all concentrated on that Western European development approach. By the initial times of industrial revolution, villagers had been encouraged to act or transformed to workers by moving to industrialized cities from rural areas. Sailors had become merchants by geographical discoveries in the new world. Trade boom were affecting the social status of the classes. Bourgeoisie had got privileges and transformed to policy makers or capitalist schemers by the socio-economic revolution. The sense of trade had also been seen as the key feature of wealth issues. Merchants, sailors, and other trader social groups were also got started to trade in the so-called new world like North and South America. On the other hand, the early owners or inhabitants

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of these territories had perceived them as exploiters. Not only the all commercial goods but also even humanity as slavery was the matter of trade during the mercantilist and the following capitalist growing stage of the western world.

The shipping and trading companies had been developed and professionally organized under these circumstances. Expanded economic relations had built up the basis pillars of financial system. Savings, investments and the other monetary-trade relations shaped under that complicated market conditions. Regulations, governments, communities and joint-stock companies were structured under these capitalist wealth objectives. The western Europeans had shaped the prototype of current global market idea in the mentioned period respectively.

Under these conditions, early in the 18th century, the private stock markets were going to serve up for capital gains of communities and individuals became shareholders of this overseas commerce. Various joint-stock companies emerged in the market and attracted more and more investors by the time. The number of companies grew from 11 to over 100 in the 1690s Europe, even more in the opening decade of 18th century. In addition, for stabling the economic system under the capitalism order, banks were founded. Barrowers and lenders were systematically meet up in those places. For instance, Bank of England (BE) was created (1694) by a coalition of Whigs (political group) and the London mercantile establishment inspired by the Dutch system of finance. Banking and financial system took place in the economics history under the aim of wealth objectives.

2. THE ROLE OF BANKS, STOCK EXCHANGE AND JOINT STOCK COMPANIES IN THE 18TH CENTURY U.K.

A group of London stock jobbers (dealers) and financiers, who had supposedly been meeting in the coffee houses in the heart of the city, were finally organized under what became known as the London Stock Exchange (or Royal Exchange), similarly formed on the Amsterdam Beurs (of 1608). Hence, the following joint-stock companies were accepted to operate in the London Stock exchange under the hidden eye of the government:

- the East India Company (or New East India Co. of 1698),
- the Royal African Co

- the Hudson's Bay Co,
- the newly founded Bank of England (BE),
- the South Sea Co. (1711).

In the 18th century, stock exchanges major activity was trading in government debt instruments called 'consols' [Consolidated Stock of the Nation'] (Munro, 2008: 6). The banks could also be used for government finance in this era.

Therefore, as Adam Smith discerned the role Bank of England and its size in the private banking system; "the bank acts, not only as an ordinary bank, but as a great engine of state". The community trust in the bank is based on the guarantee of the British government "the strength of the bank of England is equal to that of the British government" (Smith, 1776: 424). However, whether it was the Bank of England or a private bank, according to Smith, one principle underlies the contribution of a banking system to enhance the wealth of the nation – it facilitates the instrumental role of money…- (Evensky, 2005: 147). In contrast, BE was "*acted as the king's credible commitment to Parliament*" (Yang, 1997), and used for government debt financing (actually during wars) in many times.

Therefore, not only the banks but also the joint-stock companies were the great financial suppliers of the government. Her majesty the queen granted her royal charter on the 8th day of September 1711, integrating the subscribers of governmental debts by the name of "The Governor and Company of Merchants of Great Britain trading to the South Seas." Many exclusive privileges were provided to that company, and the rich commercial franchises through which they were invested, secured to traders the enjoyment of the trading monopoly of half the southern and western world. The initial proposition, which appeared in England for the establishment of a company with profitable, privileges, opened a trade to the South Sea against Spanish merchants (Hunts, 1840: 97-98). South Sea Company quickly became one of the major joint-stock companies in UK. The royal government was acting the shadowed lead role during the establishment period of the company.

"*Previous to that period, and particularly in the reign of Queen Elizabeth, many adventurers had made voyages to America, and upon their return published such glowing accounts of the trading advantages to be acquired there, as filled the minds of the English people with the most extravagant visions of future wealth, while their thoughts, which were but newly opened to the advantages of foreign commerce, excitedly pictured the*

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speedy acquirement of unlimited and princely riches from the trade in those seas" (Hunts, 1840: 98).

On the other hand, there were widening conflicts between the European states. Under the war circumstances of the nations, government expenditures and fiscal debts were dramatically increasing. Budged deficits, tax burdens, monetary failures and diminishing revenues were putting the governments under pressure likewise UK. Thus, new blood [liquidity] needed for governments.

Trade organizations with the new world created beneficial opportunities for the traders. In addition, competition among the nations (such as Spanish, Dutch, French and English merchants), paved the ways of cooperation under government-supported joint-stock companies or vice versa.

Adam Smith trained his vision on the principal form of corporate business in his era: the so-called joint stock company… Less than two centuries old in concept, this risk-sharing system had been evolved during Smith's lifetime into a dynamic driver of an expanding economy. It brought the famed "East India" companies backed by the Dutch, French, and British governments. Moreover, it gave rise to Britain's own "Hudson's Bay" and "Massachusetts Bay" companies, which in turn helped build a new wealthy nation. In further corners of the world, there were the "Royal African" Companies and the once-powerful "South Sea Company" (Robert, 1998; 68). These companies could be expected to be as the veins for the blood [or liquidity].

"The South Sea Company, later dubbed "the Earl of Oxford's (Robert Harley) *masterpiece", was established as a joint stock company. The Tory government hoped that it would eventually challenge the Bank of England and the East India Company as a provider of loans to support national debt"(Thomas, 2003).* Actually, "war debts" had been seen as the main part of that national debt.

As Adam Smith declared: "*Joint stock companies, established by Royal Charter or by Act of Parliament, differ in several respects, not only from regulated companies, but from private copartner"* (Smith, 1776; 989).

The mainstream of the joint-stock companies were distinguished under law as an extended form of a partnership, with investors as shareholders, more willingly than as separate legal entities. In theory, shares of these companies will bring more gain to investors under free market conditions. Thus, when the system was over loaded and managerial faults,

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errors or wars between countries appeared, the companies shareholders would be damaged according to fall of the companies financial value and by indirect lending (debt swaps and options contracts between company stocks and government outstanding debts) to government respectively. In addition, such speculations would readily cause manias among investors and so-called bubbles made unwilling disastrous effects on the system. None of the players (traders, individuals and governments) considers the legal regulations during the booming period. Thus, when the bubble occurred in the system it became too late to survive for the losers and wealth was suddenly evaporated.

Famous financial bubbles:

1. *The Dutch Tulip Bulb Bubble 1636*
2. *The South Sea Bubble 1720*
3. *The Mississippi Bubble 1720*
4. *The late 1920s stock price bubble 1927-1929*
5. *The surge in bank loans to Mexico and other developing countries in the 1970s*
6. *The bubble in real estate and stocks in Japan 1985-1989*
7. *1985-1989 bubble in real estate and stocks in Finland, Norway and Sweden*
8. *The bubble in real estate and stocks in Thailand, Malaysia, Indonesia and several other Asian countries 1992-1997.*
9. *The surge in foreign investment in Mexico 1990-1993*
10. *The bubble in over-the-counter stocks in the United states 1995-2000* (Kindleberger, Aliber, 2005:9)
11. The bubble in mortgage, toxic bonds, CDOs and derivative instruments in the United States 2008.

An imperative distinction is made in the literature between bubbles that result from rational as opposed to irrational behavior; *It has been suggested that, broadly, the former arise from three causes, self-fulfilling expectations ('rational bubbles'), mispricing of fundamentals ('intrinsic bubbles'), and the endowment of irrelevant exogenous variables with asset pricing value ('extrinsic bubbles'). The South Sea Bubble has been attributed to each of these causes* (Dale, 2005:236). It might be seen usual for individuals, traders and merchants to act irrationally, but what if the governments acts irrational, what would happen in the system? Is South Sea Company case giving us evidence?

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3. THE SOUTH SEA BUBBLE CASE

The commerce of almost the entire South American coast was granted upon The South Sea Company (Hunts, 1840: 99). According to Encyclopedia Britannica: the South Sea Company, founded in 1711 to trade (mainly in slaves) with Spanish America, on the statement that the War of the Spanish Succession, then drawing to a close, would end with a settlement permitting such trade. The company's stock, with a guaranteed interest of 6 percent, sold fine, but the significant peace treaty, the Treaty of Utrecht made with Spain in 1713, was less constructive than had been expected, imposing an annual tax on imported slaves and allowing the company to send only one ship each year for general trade. The success of the first voyage in 1717 was only moderate, but King 3rd George I of Great Britain became governor of the company in 1718, creating confidence in the enterprise, which was soon paying 100 percent interest*. The shadowed lead role was lightened. The public trust for the company had been set.

Adam Smith stated that; The South Sea Company, as long as continued to be a trading company, had an exclusive privilege confirmed by Act of Parliament; as have likewise the present United Company of Merchants trading to the East Indies (Smith, 1776; 991). By that way, the parliamentary support provided for the company.

The company was authorized to appoint courts of judicature in their forts, factories, and settlements, for determining mercantile and maritime cases, with the right of appeal to her majesty in council, and empowered to raise a military force, to guard and protect the vast interests which would supposedly be created by their commercial intercourse with the nations inhabiting the new world. Furthermore, the extended operations of the company should be wholly unembarrassed, and free from all pecuniary difficulties, eight thousand pounds sterling were allowed by the English government for the expenses of management; and all the commercial rights and extraordinary powers with which they were invested, were declared to be continuous. In 1719, the capital of the company was further increased to nearly twelve millions of pounds sterling; and a subscription for 520,000 pounds of their stock was opened, which was sold at 114 per cent (Hunts, 1840; 99). Financial assistance had come out for the company.

*http://www.britannica.com/EBchecked/topic/556389/South-Sea-Bubble

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Adam Smith views on the company were as follows:

"The South Sea Company never had any forts or garrisons to maintain, and therefore were entirely exempted from one great expense to which other joint stock companies for foreign trade are subject. But they had an immense capital divided among an immense number of proprietors. It was naturally to be expected, therefore, that folly, negligence, and profusion should prevail in the whole management of their affairs. The knavery and extravagance of their stock-jobbing projects are sufficiently known, and the explication of them would be foreign to the present subject. Their mercantile projects were not much better conducted. The first trade, which they engaged in, was that of supplying the Spanish West Indies with Negroes, of which (in consequence of what was called the Assiento contract granted them by the Treaty of Utrecht) they had the exclusive privilege. But as it was not expected that much profit could be made by this trade, both the Portuguese and French companies, who had enjoyed it upon the same terms before them, having been ruined by it, they were allowed, as compensation, to send annually a ship of a certain burden to trade directly to the Spanish West Indies. Of the ten voyages which this annual ship was allowed to make (only one ship had a voyage)..."(Smith, 1776; 994).

Not surprisingly, the South Sea became favorable and popular among the investors. However, as Smith declared, the company was a tragedy. The company had strong vision however, in reality there was no active business situation. Thus, its stocks in the financial markets were appreciating rapidly.

In 1720, there was an incredible boom in South Sea stock, because of the company's proposal, accepted by Parliament, to take over the national debt. Every thing had been seen legal.

The company expected to recover itself from expanding trade, but primarily from the foreseen ascend in the value of its shares. South Sea shares, which had already advanced from £130 in February 1720 to over £300 in early April, rose further to £400 (20 May), then to £500 (28 May) before touching £600 on 31 May. This plumb ascent continued into the following month, the share price breaching £700 on 1 June and £800 on 4 June. On 23 June, the Company closed its books for two months in order to process the midsummer dividend, so that quoted prices during this period are in fact forward prices 'for the opening of the books'. The highest (forward) price was £1,050, recorded on 25 June, but when the books were reopened, the spot price had fallen to £820 (cum dividend). Thereafter South Sea stock weakened dramatically to £520 in mid-September, £290 at the beginning of

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October and a low of £170 on 14 October 1720. The bubble had burst (Dale, 2005:236), (see Figure 1.).

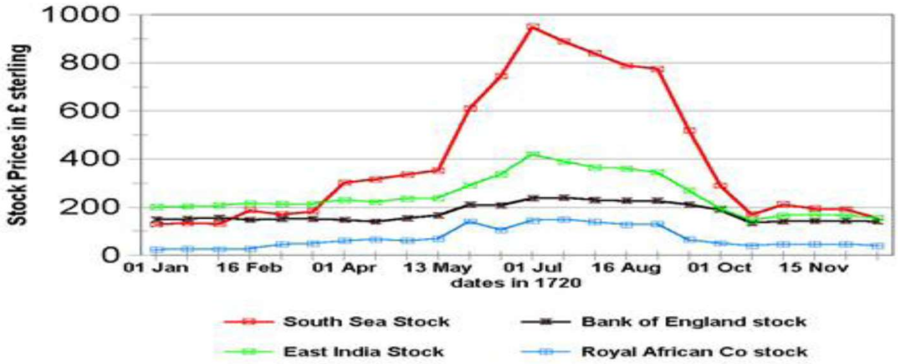

Figure 1. Stock Prices of Selected Companies (1720) Source: Munro, 2008.

There is some controversy about the aims of the foundation of the South Sea Company. Kindleberger (2005) and Neal (2006) believe that the primary motivation was the funding of national debt. In fact, only the beginning stage of the century, UK was spending annually 5.5 million pounds to maintain 90.000 strong army in the Continent, 40.000 naval forces at sea (among nearly 5.6 total population in UK, (Wrigley, Schofield, 1981)), besides 9 percent of UK national income was also absorbing by the government. (Dale, 2004: 41).

In summary, the total government debt at the end of 1719 was £50 million:

- £18.3m was held by three large corporations:
  - £3.4m by the Bank of England
  - £3.2m by the British East India Company
  - <u>£11.7m by the South Sea Company</u>
- Privately held redeemable debt amounted to £16.5m
- £15m consisted of irredeemable annuities, long fixed-term annuities of 72–87 years and short annuities of 22 years remaining maturity (Dale, 2005).

The same scenario had been witnessed in France.

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4. FRENCH MISSISSIPPI BUBBLE

Actually, the similar case observed in France previously as it had known as John Law's System. National debts of the government were unsuccessfully tried to erased by Law's operation (latterly finance minister of France, who fled from the country in 1720) the company after such mergers and acquisitions called French Indies Co. as well. The summer of 1719 brought far-reaching changes in Law's operations. Formerly established private banks in France had also nationalized and directly became accountable only to the king under economic recovery of the beginning episode of French Mississippi Bubble. Having bought out virtually all the trading companies then in existence, the Indies Company branched into tax collection and "royal mint" management. At the same time, it planned refinancing the whole national debt at a lower interest rate. For financial assistance of this operation, the Company proceeded as it had done with its earlier acquisitions, with further share issues, at prices that tracked the bullish market. The operation ended up being a transferring of government debt into equity in a company that, all at once, collected virtually all the taxes in France (Velde, 2008: 151). According to Verde, the name of British version of this operation was called the South Sea company. In contrast, tragic results were similar in both two cases.

Becoming distressed at the number of new rival companies to South Sea Company, the government passed the Bubble Act (6 Geo I. c. 18) on June 24 1720, making it illegal companies without a royal charter to operate. The act was instigated by the South Sea Company directors who, wishing to enforce their monopoly, quickly applied for writs against four companies trading without a royal license. The shares of English Copper, York Buildings, Royal Lustreing and Welsh Copper plummeted as a result (Grace, 2009: 36). The action of the South Sea directors was to lead to their downfall.

The privileged the market value of South Sea stock, the more attractive would be the incentive for outstanding government debt holders to exchange existing government debt for South Sea Company stock, and the more attractive for the corporations, which would need less stock per unit of debt redeemed. Therefore, the incentives were set for the directors of the company to focus on the market value of the existing stock. Then the company decided to do so in a number of stages or subscriptions. Such was the passionate response by debt holders that, with each successive

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subscription of new stock, the price of South Sea shares raised spectacularly, and with it the share prices of other companies. In 18th century UK, reputation was essential during this period of growth of the public debt. The redemption of an annuity raised issues of asymmetric information, moral hazard and fairness (Chamley, 2008: 174).

Adam Smith's views continue as: *The trade of a joint stock company is always managed by a court of directors. This court, indeed, is frequently subject, in many respects, to the control of a general court of proprietors. But the greater part of those proprietors seldom pretend to understand anything of the business of the company, and when the spirit of faction happens not to prevail among them, give themselves no trouble about it, but receive contentedly such half-yearly or yearly dividend as the directors think proper to make to them. This total exemption from trouble and from risk, beyond a limited sum, encourages many people to become adventurers in joint stock companies, who would, upon no account, hazard their fortunes in any private copartnery. Such companies, therefore, commonly draw to themselves much greater stocks than any private copartnery can boast of. The trading stock of the South Sea Company, at one time, amounted to upwards of thirty-three millions eight hundred thousand pounds... The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own.*(Smith, 1776; 989-990*).*

In addition to Smith's views to prevent bubble on financial market the regulatory act issued in UK just few months before the burst.

The important enforcement provisions found in the Act are as follows:

1. Without the payment of the call, the subscriber would be deprived of any 'Share, Dividend, Annuity, or Profits' that he might otherwise be entitled to;

2. Without payment of the call, the Company could also 'stop the Transfers or assignments' of the defaulter's interests in the firm;

3. The defaulter's liability for a missed payment, plus 5 per cent per annum interest, would be met from the 'Shares and Stocks of such Defaulter'. If the subscriber persisted in default for a space of three months, the Company, or anyone whom the Company designated, could sell the defaulter's 'Stocks';

4. Even when the default persisted beyond three months, the defaulter could still obtain something of value if the sale of his forfeited stock

garnered more than his liability to the Company. The defaulter would be delivered the '**O**verplus' (Shea, 2007: 746). The act published in April 1720, but South Sea shares were still popular and its values had also climbed few months on the board. However, shareholders became uncomfortable as the "illegal company" shares began to fall by only after the bubble act issued. As Adam Smith mentioned akin to; "in all trades, the regular established traders, even though not incorporated, naturally combine to raise profits, which are no way so likely to be kept, at all times, down to their proper level, as by the occasional competition of speculative adventure" (Smith, 1776: 983). By September, the market had collapsed, and by December South Sea shares were down to 124, dragging other, including government, stock with them. This speculative adventure had end with tragedy (for instance: according to the bills of mortality, suicides in London increased by 40 percent just in London in 1721) (Dale, 2004:178). Many investors were ruined, and the House of Commons ordered an inquiry, which showed that at least three ministers had been accused of bribery and manipulation. Many of the company's directors were disgraced. The scandal brought Robert Walpole, generally considered the first British prime minister, to power. He promised to seek out all those responsible for the scandal, but in the end, he sacrificed only some of those involved in order to preserve the reputations of the government's leaders. The South Sea Company itself survived until 1853, having sold most of its rights to the Spanish government in 1750*. Unlicensed joint-stock companies remained illegal in UK until the Bubble act was repealed in 1825.

5. CONCLUSION

Classical economists and Adam Smith ideas agreed under the free market concept and trade regulations. Neo-liberal market implications could not be confronted via government interventions. Thus, the main dilemma is shaped under the question that what governments will have to do during and after the economic-financial crisis.

In the case of the government's financial requirements for public dept consolidation and irrational behavior of all parties could seen as the primary facts of South Sea Bubble. However, government had no legal entity to prevent the community before the bubble burst. The shares of the company

* http://www.britannica.com/EBchecked/topic/556389/South-Sea-Bubble

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were rising until it had reached the unexpected levels then the bubble act was issued to regulate the market but it was too late for all. The main problem can also observe in current financial crisis. Today's financial crises would be classified under secondary market conditions. Inefficient regulatory acts (or laws) in the recent crisis would affect overvalued assets of bonds trivializing the liabilities of companies and financial bodies.

The 2008-09 financial crises related to financial instruments such as certificate of deposits and derivatives exposed a situation that deserves restructured legal framework. Excess of liquidity on markets and increased financial instruments creates moral disorder (mania) among the investors. Similar to the South Sea Company situation, today's market makers have recently been trying to reorganize a convenient environment for secure capital transactions and investment.

Swap agreement between The South Sea Company stocks and the U.K. Government debt have similarities with today's financial bubble. Equities of the market players affected by the current financial crisis were to be swapped by the state issued repurchase agreements.

Financial leverage illusion implanted by neo-liberalized markets, growth of the U.S. Government debt, and unregulated money market applications on toxic bonds, resulted in refinancing need of all those results by serving the liquidity via the governments.

Finally, in the South Sea bubble and 2008-09 financial crisis, it has been noticed that the investors guaranteed and derived to the increased market bubble by the invisible permit of legal authorities to create virtual liquidity in order to finance unexpected governmental expenditures and to encourage the investors' ambition for risk taking.

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