

# The Ascent of Money

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NIALL

FERGUSON

# BLOWING BUBBLES

## **Importance of Company as a most fundamental institution after the advent of Banking**

- Kind of human organization to overcome natural barriers-Interventions in nature
- Grand projects for transforming global economy
- Pooling of resources for capital investment
- Limited liability : Rise of ***joint-stock***  
Protection of investors in case of failure

# Overview of company (features)

- Legal form : Partnership – joint stock company
- Disciplined :
  - by shareholders ( Management)
  - by Stock Market
- Upward and downward swing in prices of shares:  
Bubbles



Bursts

# The Pattern of bubbles

## Five Stages

- Displacement
- Euphoria or overtrading
- Mania or Bubble
- Distress
- Revulsion

### **Other Features :**

- Asymmetric Information(Insiders - Outsides)
- Cross border capital flows
- Easy credit terms

# The History of Bubbles : Dow Jones

- January 1973 : 1052
- August 1979 : 875
- August 1982 : 777
- Summer 1987 : 2700
- September 1999 : 10395
- October 2002 : 7286

# The role of returns in bubbles

- **Comparison of return of stocks with Bonds, Bills Starting on 1964 : *US Market***

- US stocks 70 times plus
- US Bonds 23 times plus
- US Bills 12 times plus

In nominal terms

- US stocks 10.3 times plus
- US Bonds 3.4 times plus
- US Bills 1.8 times plus

In real terms

**Starting 1920-1990 : Annual Return on US Stocks 4.73%**

# Other Markets

## *Europe 1920-1990*

- Sweden : 3.71%
- Switzerland : 3.03%
- Britain : 2.28%

## **Latin America : Negative Returns**

**In most countries returns  
on stocks outperform those  
of bonds due to equity risk  
premium**

# THE COMPANY YOU KEEP

- *John Law* : Inventor of stock market bubbles  
Scotland -> Italy -> Dutch -> France
- **Economic Developments** in Amsterdam by 1690:
  - Improvement of system of public debt
  - Creation of Central Bank (Wisselbank ) } →

***Great Innovation*** : Joint Stock Company to cover needs of trade with East (spices) –Trips of ships →

Merging of existing companies in one( **V.O.C**)



# V.O.C (United Dutch Chartered East India Company)

- Chartered in 1602
- Monopoly on all Dutch trade east of Cape of Good Hope
- Withdrawal of capital at the end of just ten years
- Subscription open to all residents
- Biggest Company in the era
- Division of capital in six provinces to avoid Rivalry
- Board of Company : 17 Lords

# V.O.C (United Dutch Chartered East India Company)

- Ownership : actions (shares) – receipts –stock Ledger
- Principle of Limited Liability –no guarantee of returns
- No Initial Success
- Problems with management
- Non payment of dividends
- Lack of cash
- No liquidation in 1612

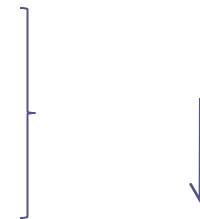
# V.O.C

## ***Results:***

- Need for sale of stocks →  
Secondary Market → Transfer of Stocks  
↓  
Building of Beurs (1608) →  
Acting of Bulls & Bears
- Foundation of Amsterdam Exchange Bank(1609)
- Link between Stock Market and Banks
- A new kind of Economy :  
Triangular: Company-Beurs-Banks

# Reform of VOC

- Efforts to put pressure by critics
- Short Selling (Maire)
- Lack of Transparency



## *Reform of VOC*

- Chartered modified (1622)
- Directors for only 3 years
- ‘Nine Men’ (main shareholders) to be consulted by 17 Lords on important matters , to participate in meetings with no vote right (1623) & appointing of auditors for checking accounts

# Reform of VOC

- Standard dividend 12.5% (1632)
- Distribution of all profits
- Replacement of capital expenditures with issue of bonds
- Good credit (1670)
- ***New Strategy of Voc :***
  - Trade war raged by Jan Pieterszoon Coen
  - Expansion of Dutch power
  - Aggressive strategy

# Results

- Establishment of effective monopoly on exports
- Hub of intra-Asian trade (Japan, India)
- Provision of financial services in Asia
- Consolidation as world's first big corporation with external scales of economy
- New compensation systems to promote investment and sales

# Share Price of VOC -No Bubbles

- Long term upward trend 1602-1733 rise from 100 to 786
- Capital Appreciation
- Annual rate of return 27% (1650)
- Gradual rise in price
- No bubble until 1794

# Explanation given :

- Relationship : Company –Exchange Bank-Stock Exchange
- Financial Reform
- Restrictive policy
- No application of Law's ideas



# Safe as Houses

## **Aristocracy :**

- Privilege of ownership-vote
- Political decline : Finance –Industrialization-Borrowing
- Fall of landowners income in England :
  - High interest
  - Fall of prices
  - Decrease in tariff barriers
  - Cut in transport cost

# Evidence of fall

## Case of Stowe House

- Owner : 2nd Duke of Buckingham-Richard Grenville
  - Victim of property crash
  - Resistance failed
  - Decline due to extravagant life , high debt, renovation costs  
↓
  - Auctions of House (1848)
  - Personal Degradation
  - Appointment of his son as chairman of railway company
  - Degradation of title

# Start of new democratic age

- **Electoral Reforms** : 1832,1867,1884
  - Vote right to no landowners
  - Removal of economic qualifications (1918)
  - Universal vote (1928)
  - No universal property (1938)
- **Home-owning Democracy** :
  - Born in USA
  - Few house owners (before 1930)
  - Mortgages used

# Start of new democratic age

- **Consequences of Depression in USA :**
  - Foreclosures
  - House prices slump
  - House industry collapsed
  - Countryside: Land prices -50%
  - Cities: unemployment, despair, social unrest (1932)
- **Efforts of conciliation:**
  - Initiative of Edsel Ford to remove class conflict and promote social peace
  - Invitation to communist Diego Rivera for painting of murals
  - Reactions followed
  - Arts failure

# Response to crisis

- **Depression** brought:
  - Totalitarian regimes in many countries
  - Expansion of Communist ideas
  - Social measures by Frank Roosevelt in USA
- **New Deal:**
  - Aims pursued : regain of confidence , protection by Communism, promotion of property owning democracy and support of housing
  - Measures applied :
    - intervention in markets
    - budget spending on low cost home
    - foundation of agencies for encouraging & overseeing mortgages
    - Federal deposit insurance (1933)
    - Refinancing of mortgages

# New policy in housing

- **Federal Housing Administration (1834) :**
  - Improvement of mortgage terms
    - increase of price percentage financed
    - Lower interest rates
    - Amortization applied
    - Expansion of duration of loans
- **Standardization of long term mortgages:**
  - Creation of national secondary markets in home loans
  - Foundation of *Federal National Mortgage Association* (1938)
    - Issue bonds
    - Buy mortgages
    - Provide liquidity to Savings & Loans
- **Regulation Q :** limit on deposit rates to avoid ruins

# Results of new policy

- **Underwriting of mortgage market :**
  - Soaring of property ownership & mortgage debt
  - 60% home ownership (1960)
  - Real estate development in Detroit
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- **Racial segregation**
  - Discrimination in interest rates
  - Red-lining for blacks
  - Start of civil rights struggle
  - Riots (July 1967)
  - Need for political response to violence
  - Community Reinvestment Act (1977) –lending to poor community

# Repercussion in Britain

- Subsidies of housing
- 50% owner occupied (1971)
- Tax deduction on interests until 30,000£ (1983)
- Policy in favour of housing by both Labour and Conservatives
- Thatcher as Reagan facilitated home ownership
- Share of owner-occupiers 67% (1991)



# From Boom to Burst

- ***New policy in housing :***
  - Interest rates lower than inflation rates (1960-1970)
  - Real value of debts decreased
  - Property prices trembled (1963-1979)
  - Consumer prices rise by 2.5
  - Contrast of price stability with property owning democracy
  - Need to curb inflation
    - ↓
    - Higher interest rates
    - Rise in cost of house borrowing
    - Ruins
    - Burst in property market