Why did innovation in state finance spike during the 1719-20 equity boom? A pan-European perspective

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Although scholars have long known that the Mississippi Bubble, the South Sea Bubble and the Dutch Windhandel of 1719-20 were connected and represented together the first international financial bubble, little research has been undertaken on the transnational dynamic of the equity boom. Drawing on extensive archival research, I demonstrated in a previous paper that speculation and stock euphoria spanned from Portugal to Russia, and from Sicily to Sweden. This study goes one step further. It argues that financial innovation, and in particular innovation in government finance, was the most important factor explaining the timing, dynamic, and geographical scope of the 1719-20 pan-European equity boom. Innovation is here defined broadly as a) development of new ideas (four major financial ideas were implemented in 1719-20, including two different types of securitization of the whole sovereign debt) and b) adoption of ideas, no matter how old, in new countries.

The paper underlines four aspects in particular. First, mechanisms of learning, imitation, and especially competition among states explain the rapid diffusion of financial innovation in 1719-20. The innovation literature distinguishes two main factors of competition: *location-choice* and *spillover-induced*. Both played a key role in 1719-20: *location-choice* concerned the competition for international trade and capital flows; the *spillover-induced* effect resulted from the fact that contemporaries perceived innovation in state finance as something that could potentially transform the balance of power in Europe. This latter factor explains a great deal of the emulation between France and Britain. When France – the largest European economy of the time – began implementing a massive debt-to-equity swap of its long-term debt (August 1719) it immediately created a potential demand for public finance engineering among its neighbours: Britain could not afford to stay on the sidelines, and many other countries progressively followed suit; financial innovation spiked as a result.

Second, to fully understand what happened in 1719-20 it is not sufficient to take into account the state; other actors played a key role: projectors, investors, and state officials. There was, for instance, a dialectic relation of demand and offer between governments and projectors. There is also evidence (in particular in the Austrian Netherlands, Britain, Portugal,

and Spain) that ministers "sold" their support to competing syndicate of projectors. Furthermore, there is ample evidence that investors favoured schemes where they perceived that their interests would be aligned with the state and/or with state officials: whether because the state, or state officials, invested in the enterprise (this was the case, for instance, with the Mississippi and South Sea companies); whether because the scheme itself created this perceived alignment (such as in debt-to-equity swaps).

Third, the most distinctive feature of 1719-20 was that governments and projectors systematically embedded financial innovation into joint-stock companies. This meant, among other things, that the spike in financial innovation across Europe coincided with an extraordinary pan-European equity boom. It is noteworthy that approximately 40% of all the European initial public offerings of shares (IPO) of the seventeenth and eighteenth centuries took place in 1719-20. Yet, many joint-stock undertakings promoted in those two years foundered before reaching the IPO stage. This was particularly the case in those countries that had not yet developed an active stock market (Spain, Portugal, the Austrian Netherlands, Piedmont, Russia, etc.) There, projectors faced the difficult task of introducing two innovations at once: public finance schemes and a secondary market for shares. Still, this was achieved at least in one country: Lorraine, where a company was successfully floated (November 1720) thanks to the active support of the government.

Fourth, the crash of the Mississippi and South Sea Bubbles (summer-autumn 1720) did not immediately slow down the pan-European process of innovation. Governments and projectors endeavoured at first to innovate even further; they tried in particular to devise schemes that would tame speculation (for instance in Spain, Portugal, Switzerland and Ireland). The double crash had nonetheless an adverse effect on those governments (including the Dutch Republic) that were considering implementing debt-to-equity swaps. Furthermore, the crash provoked an inflection in the spread of innovation: projectors and governments abandoned the types of undertakings that involved a high degree of financial engineering (such as securitization), concentrating instead on less sophisticated schemes (such as the sale of rent-generating privileges to a company).

Emulation between Spain and Portugal was the last significant engine that kept pushing forward the process of innovation till the end of 1720. The spike in financial innovation thus lasted approximately one year and a half (August 1719-end 1720). Never before, and rarely afterwards, so many financial innovations were developed, discussed, embraced, rejected, by so many countries all over Europe in so little time.