

A Brief History of Scams that Broke the Economy

Simon Ritchie

Scams

I worked in the Internet business through the “dot com” boom of the 1990’s. While I was out of work during the crash that followed I read a book about the South Sea Bubble. The book’s story of naked greed, bribery, deception and resulting financial disaster was familiar, because I’d spent the last few years in a similar environment, working for people with a similar lack of moral standards and watching helpless as it all went wrong.

I also noticed that both of these booms and crashes had at their core some mysterious technology that few people understood but that promised great wealth. In both cases the technology really did have huge potential. The problem was that the snake oil salesmen in charge didn’t understand it, but everybody else assumed that they did. It turns out that this is a common theme in financial disasters that wreck economies.

The Darien Scheme 1693-1699

The technology in this case was the wooden ship and the ability to navigate across the oceans.

Wooden boats seem primitive to us, but as anybody knows who’s tried to sail one, making them work takes a lot of skill. By this time, European nations in general and the British in particular had developed heavily-armed and well-provisioned ocean-going ships that could go to sea for months or even years and carry valuable goods between continents. They were the high technology of their day. They were very expensive to build, equip and run but, if used properly, they could be used to make a lot of money. Then as now, the average person in the street knew this, but had no real idea how the technology worked. This could be used to part them from their money.

Another problem with wooden ships was, once the ship had left port, the owners had little or no control over what it did. The sailors on board made the decisions and they had their own interests.

By now The East India Company controlled large parts of the Indian subcontinent and traded across the East Indies, shipping the goods back to Europe. It made huge profits for its shareholders.

The Company of Scotland Trading to Africa and the Indies was set up in Edinburgh in 1693. The plan was to create a Scottish colony in Darien - what we now call the Isthmus of Panama. That’s the piece of land 80 Km wide joining North and South America and separating the Atlantic and the Pacific. Once the colony was established, it would control an easy route between the two oceans, removing the need to sail around Cape Horn. The word “Africa” in the name is a clue that there plan also involved transporting and selling African slaves.

Thousands of Scots from ordinary folk up to aristocrats invested £500,000 in the scheme, estimated to be about half that country’s available capital.

What the Scots didn’t take into account is that separating two oceans generally involves a fairly chunky piece of rock, and this particular piece of rock was a hell-hole of mosquitoes, malaria and other diseases to which most Scots had little resistance. It’s not great farming country either, so growing food was going to be a problem. Also, the Spanish didn’t take kindly to the idea and attacked the colony.

Between 1698 and 1699 three fleets of ships took 2,500 colonists over to Darien. Most of each group died from disease and Spanish attacks, but that news didn't get back until too late. The second and third groups expected to be join an established colony, but found only devastation when they arrived. Only a few hundred colonists survived to return to Scotland.

The investors lost their shirts and the resulting hit on the Scottish economy is thought to have been a major factor in persuading the Sottish aristocracy to accept the Act of Union and the formation of the United Kingdom in 1709.

And those pesky sailors, with naughty ideas of their own? The ships took trade goods over as well as colonists. The investors' plan was to exchange the goods for gold and bring it straight back to Scotland. Instead, the crew exchanged the goods for slaves, sailed to Madagascar and sold them. During the celebrations that followed, the ship was stolen by pirates and never seen again.

That's the thing about technology that few people understand. Those that do, can't always be trusted to act in the interest of their investors, or even to act sensibly.

The South Sea Bubble 1711-1720

The South Sea Company also involved ocean-going wooden ships and the slave trade, plus another piece of mysterious technology: the merchant bank.

The Bank of England was at the time a private company and in theory had a monopoly on servicing the British Government's debt, but the Government was unhappy with the Bank's offering and turned a blind eye to the rules when somebody else offered an alternative service.

The ending of the War of the Spanish Succession in 1713 promised opportunities in South America similar to those enjoyed by the East India Company. The Treaty of Utrecht that ended the war gave the British the right to sell African slaves to the Spanish and Portuguese Empires, in theory at least.

The idea behind the South Sea Company was to make money by selling slaves in South America and bringing goods back to Europe, **and** by servicing the British national debt. The Company did a great job of publicity about its prospects, but making actual money through trade doesn't seem to have been its strong suit.

The money from slavery and other trading never materialised. Having agreed to allow it, the Spanish put so many restrictions on it that voyages were few and none were profitable. Oh well, onwards and upwards!

In 1718 the Company persuaded King George 1st to become its Govenor (what we would now call its chairman of the board). That gave the company's respectability a huge boost. Apparently the Company gave a large tranche of shares to the king's favourite mistress and pointed out how the value would go up if her friend George was seen to support the company. This was a ploy they used many times – find somebody with influence, give them shares and get them to promote the Company.

The company kept the share price up by paying high dividends but by now, it didn't have sufficient real income to do that, so they used the money from share sales. It was the first Ponzi scheme.

By 1720 they had enough shareholder's money to buy the national debt of £32,000,000. The British government no longer seemed to its creditors to be a good risk and they sold the debt for £7,500,000. The Government approved the deal on the understanding that it would then pay a low interest rate on the debt to the Company.

Given that nothing could possibly go wrong, many people borrowed money to invest in South Sea stock.

At its highest point in August 1720 the share price reached £1,000. The bubble finally burst and by September it had fallen to £124, losing 80% of its value and bankrupting thousands.

There was, shall we say, a bit of a fuss about this, but the Government was in a bit of a bind, given that the King was involved. The resulting investigations revealed bribery and corruption on a grand scale, but they had to be limited. When the Company crashed, the chief accountant did a runner with the books. He was arrested abroad but the British sent secret agents to spring him from prison and help him disappear. Some scandals are best left buried.

The financial fallout was devastating to the economy. Large numbers of people at all levels of society were bankrupted, even some of the very rich. Sir Isaac Newton is said to have lost the equivalent in today's money of £40,000,000. Further down the social scale, tradesmen who had lost money could no longer afford to carry on in business.

The bursting of the South Sea Bubble had a disastrous effect on the British economy.

The Nineteenth Century – Railways, the Telegraph, the Telephone and Mains Electricity

The 19th Century was an age of revolutionary inventions, all involving new and mysterious technology. The telegraph and telephone shrank the world. Mains electricity lit the streets and houses and allowed a completely new lifestyle. All of these inventions were exploited by cranks and charlatans (radium corsets anybody?) but not all scams promised to crash the economy.

Railways seem to have been particularly powerful wealth-destroyers. They cost eye-watering amounts to build, took years to turn a profit and were often built in places far away from the investors. The opportunities for fraud were enormous. Many people in Britain lost fortunes in the 1840 Railway Mania and failed railway projects in the USA contributed to the panic of 1873, said to be the first international financial crisis.

The 1990's Dot Com Boom and Bust

It has been said that to really mess things up, you need a computer.

The Internet came out of academia in the 1980s, when universities and large companies joined their networks together into one that spanned the western world. In 1989, Tim Berners-Lee, a researcher at CERN, proposed The World-Wide Web, a way to share documents across the Internet. Meanwhile, access to the Internet was widening and in the 1990s ordinary folk were allowed to access it from home via telephone modems.

The web allowed the creation of web sites that sold things, which was seen as a sure-fire way to make money. If you build it, they (endless numbers of customers) will come!

Throughout the 1990s, companies rushed to build web solutions, without caring too much about they were a solution to. Investors small and large rushed to get into the rising market. Companies that were seen to have a good Internet Strategy saw their share value balloon. Companies that were not in the dot com sector struggled to make it look as if they were.

On the ground, executives who knew nothing about computer systems and had spent their careers leaving such things to their IT departments were suddenly expected to oversee a revolution in their business with complex computer systems at its core. Meanwhile, IT managers used to bolting together standard packages to create back office accounting systems were expected to implement this revolution. In most cases, neither group was ready.

The boom ended in early 2000 when it became clear that a lot of of the money spent on Internet initiatives had been wasted. Companies that were a going concern found their share value slashed to a fraction of its former self and others went bust altogether.

There was outright fraud as well. The executives of the companies were rewarded by being given shares, so it was in their interests to keep the share value high, by hook or by crook. For example, throughout the boom, Enron presented itself as a dot com company when it was really just an electrical supply utility. Eventually, it was also bankrupt, but used financial trickery to conceal that fact. WorldCom, on the other hand, was a genuine dot com company, but its executives used other trickery to artificially inflate the share price. These revelations contributed to the eventual dot com crash.

Trillions of dollars of investors' money vanished overnight. Millions of small investors lost their savings and economies around the world tanked.

We were just getting over the worst of that crash when, on September the Eleventh 2001, terrorists flew two jet aircraft into the Twin Towers.

The 2008 Sub-Prime Mortgage Boom and Bust

The technology behind sub-prime mortgages was in essence quite simple. If you lend money to buy a house to people who can well afford to pay you back (prime borrowers), the risk of them defaulting on the payments is fairly low, but there are not many such people. If you lend money to less well-off people to buy a house (sub-prime borrowers), there is a bigger risk of them defaulting, but you can get at least some of the money back by foreclosing and selling the house. The idea behind the sub-prime mortgage market was to bundle prime and sub-prime mortgages together using a clever piece of mathematics that balanced up the risks to produce an acceptable aggregate.

These bundles of mortgages became a new kind of financial instrument that could be traded between banks. The idea took off and the market grew. Banks expanded and became dependent on sub-prime mortgage bundles for their supply of money. At the same time they became over-leveraged – their ratio of loans to deposits was too high to be safe.

A number of things went wrong at once.

It was discovered that some of the bundles of mortgages had been pulled apart, re-arranged and sold on. The seller had kept the prime mortgages and dumped the sub-prime component onto another bank.

Many sub-prime mortgages had an interest rate that went up over time on the assumption that the borrower's income would increase. When that didn't happen, the borrower defaulted, in large numbers, all at once.

The sub-prime market caused a housing bubble which eventually burst, reducing the value of housing stock. The bank could foreclose and sell the house, but it would not get so much as expected.

Another way to look at the scheme is that it depended on persuading millions of poor people to buy houses that they could barely afford, while interest rates were low. Standing back, that doesn't seem like a smart idea. The clever mathematics failed to predict what would happen if the economy became overheated and interest rates went up – more people defaulted than expected.

The value of sub-prime mortgage bundles collapsed very quickly, suddenly putting the banks that owned them at risk. I read that, a few days before Lehmann Brothers went bankrupt, the CEO said "What do you mean we're running out of money? This isn't the kind of money that you can run out of!"

But it was.

We know the rest. All of a sudden, a major asset holding up the banking system lost most of its value. The banks were too big to fail and the Government was facing the cash machines being empty the next morning. The government was forced to print money to support the economy, which caused massive inflation and put us where we are today.