

THE GERMANS have issued a declaration of war to financial market speculators. Angela Merkel, the under- pressure chancellor, stood behind a ban on the naked short sale of shares in the country's leading financial institutions and the bonds of euro-zone countries until March of next year. The ban also includes the purchase of credit default swaps on euro-zone government bonds other than for hedging purposes.

The decision is politically motivated and follows her bruising defeat in North Rhine- Westphalia, which reflects widespread public discontent with the decision to lend to the fiscally challenged Greeks. The move is misguided and the Germans have become the latest in a long line to shoot the messenger, rather than point the finger at the reckless lending of financial institutions or the uncontrolled spending of spendthrift nations.

Short-sellers have been deeply unpopular throughout financial history and have been singled out incorrectly by officialdom as propagators of financial crises ever since the first sophisticated stock market emerged in the Dutch Republic during the 17th century.

Joint-stock companies first appeared in England in 1555, with the incorporation of the Company of Merchant Adventurers by royal charter, under the name of the Muscovy Company. The charter gave the company a legal basis for its activities and it was granted a monopoly on trade with Russia.

The innovative structure enabled ambitious merchants to raise sufficient private capital to fund their high-risk ventures and the pooling of funds allowed wealthy investors to contribute only a portion of their capital, and thus, minimise their potential losses. The joint-stock form proved popular and the Muscovy Company was soon followed by the Eastland Company in 1579 for trade with the Baltic States, the Levant Company in 1581 for trade with Turkey and the British East India Company in 1600 for trade with the Far East.

Although the new investment vehicle was quickly adopted as a means to fund high-risk ventures, shares in the English companies rarely changed hands because the stock was closely held by a small and interconnected group of wealthy investors.

The technique was imitated across Europe, but the first active securities market emerged in Amsterdam after the Dutch followed the English example and chartered the Verenigde Oostindische Compagnie (VOC), or Dutch East India Company, in 1602.

Amsterdam was rapidly becoming the international payments centre for the 17th-century European economy and the concentration of short-term money meant that the entrepôt was the ideal location in which an active securities market could flourish.

Shares in VOC attracted considerable interest from the outset, with at least 1,000 individuals subscribing to the original issue.

The shares continued to capture investors' interest in the secondary market and turnover, which averaged 100,000 a year during the company's first four years, increased to 400,000 a year during the subsequent four-year period. However, not all investors were enamoured and some became disenchanted with the VOC, because it paid no dividends and released little financial information.

The Flemish-born merchant Isaac Le Maire, one of the original subscribers to the VOC, organised a group of well-connected Dutch businessmen in the spring of 1609 to short the company's shares. Le Maire believed that the shares would fall following the incorporation of a rival French-chartered joint-stock company, and the group began to sell forward, promising delivery in one to two years.

The shares suffered a double-digit drop in the year that followed. Upon learning of the scheme, the directors of the East India Company filed a complaint and, although the Amsterdam Bourse cited poor business conditions as the culprit behind the stock's price drop, the Dutch government outlawed short sales. The share price rebounded once it became clear that a rival French company would not materialise, and Le Maire was ruined as he failed to disentangle himself from the litigation that ensued.

Shooting the messenger has persisted through the centuries that followed. The French banned short sales following the 1720 collapse of the Mississippi Bubble inspired by Scottish-born John Law; the British did likewise in 1733 – 13 years after the demise of the South Sea Company; and Napoleon Bonaparte signed an edict in 1802 that subjected short-sellers to up to one year

in prison, which allowed Bonaparte to finance his empire-building without unnecessary interference from nuisance speculators.

The lesson from history is clear and is confirmed by academic research.

Short-sellers act as an external governance mechanism and help to prevent overpricing. Indeed, in recent times, it was the short-sellers who uncovered earnings manipulation and other accounting irregularities at firms such as Enron, Lehman and WorldCom long before they were uncovered by the appropriate regulatory bodies.

Furthermore, short-selling helps to correct overpricing that occurs as a result of the compensation structure of long-only investment management firms and the short-term performance obsession of their clients, which leaves these managers with little option but to chase price momentum.

To quote the early 20th century financier, Bernard Baruch, without short-sellers “there would be no one to criticise and restrain the false optimism that always leads to disaster”.

Short-selling contributes to efficient price discovery, enhances market liquidity and mitigates market bubbles. Officialdom should not be looking to restrict short-selling in falling markets, but looking for ways to encourage more short-selling in rising markets.

The Germans are wrong to shoot the messenger.