John Law’s Flawed but Well Intended Système

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Of the world’s many economic meltdowns spurred by desperation, overconfident leaders with too much power, and a lack of experience or transparency, the Mississippi Bubble was one of the first that wiped out an entire economy. Overexpansion and unbridled speculation led to the abrupt and drastic rise and fall of individuals’ finances, hyperinflation, the devaluation of France’s currency, and a disgraceful reputation to John Law. Law, a Scottish financier, economist, and compulsive gambler, was the master mind behind the so called Mississippi Bubble which occurred during the regency of Philippe d'Orléans. Although Law came to the duke d’Orléans in 1715 with good intentions and a seemingly magical, unprecedented plan, Law became carried away by speculation and failed to rein in the ever increasing stock price. He was in unchartered economic territory – no one had ever seriously experienced with paper money before. Ultimately the lack of knowledge, overconfidence of John Law, and ignorance of duke d’Orléans slammed France’s economy into the same stagnant, shocked state that that induced a financial plan in the first place. Abrupt and often counterproductive actions by the investors, John Law, and the duke d'Orléans, only exacerbated the situation, giving insight into irrational behavior in panics. Although Law’s economic Système (known as the Mississippi Bubble in England) could have had a profoundly positive impact on France (he started to lay the foundations for a sturdy, sound economy), the sudden lack of confidence among investors and the absence of actual value in the Louisiana territory rendered his innovations – the Banque Royale, the Compagnie des Indes, and paper money – extinct within only four short years. Law ultimately gambled away France’s economy on the misconceptions that Mississippi was filled with gold and that investors would indefinitely trust the value of paper money.

The Mississippi Bubble began in 1715 when King Louis XIV died and left the throne to his son Louis XV, who was only five. Acting in Louis XV’s place, Philippe d’Orléans, Louis XIV’s
nephew, was faced with 145 million livres in annual revenue, 142 million livres in annual expenses before interest payments, and a staggering three billion livres in national debt, which included 590 million livres in bonds called billets d’état. Even worse, much of the incoming revenue from taxes had been spent in advance because of Louis XIV’s extravagance in luxury and war.

In addition to France’s bloated debt, taxes were high and unfair. The system consisted of Receivers-General and forty fermiers généraux, or Farmers-General, who collected all the indirect taxes to a fixed sum of sixty million livres. However, the Farmers-General would often collect more than what was required and took the difference for their own consumption. Unfair privileges and exemptions stemming from bribes also permeated the corrupt environment.

To try and reduce the debt, the duke d’Orléans in 1716 forced the Farmers-General to pay the government some of what they had taken. He fined and confiscated land and valuables of corrupt government employees and “clipped” coins to 80% of their original value. These measures angered many citizens, yet paid for only 6% of the debt. Unfit for the job, the duke turned to John Law, who had illustrated his plan in his *Money and Trade Considered with a Proposal for Supplying the Nation with Money* directed to Scotland. Law encouraged the growth of the economy by using livres tournois (also known as banque notes) as paper money to

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4 Ibid.
5 Ibid., 154.
capitalize on the unemployed resources such as the Louisiana territory. Like the Spanish and English, Law believed that the system of mercantilism, using colonies as a source of revenue and raw materials, could greatly enhance the economy of the mother country.

Law introduced paper money to France and the world. He stated, “Money is not the value for which Goods are exchanged, but the Value by which they are Exchanged: The use of Money is to buy Goods, and Silver while Money is of no other use.” Gold, silver, and paper money alone are rather useless (one cannot eat them or use them to build shelter or clothing), but act as a means of exchange based on faith, consensus, and confidence. Law believed that using paper money would be less dangerous than silver because both are only as valuable as the extent that people deem them to be, but paper money is lighter and easier to formulate, which would increase business and trade because of the fluency of the currency. Originally Law promised that “Paper-money propos’d will be equal in value to Silver, for it will have a value of Land pledg’d.” Unfortunately, Law did not uphold this guarantee and printed vast amounts of paper money.

To facilitate this circulation of paper money, Law opened the Banque Général (also known as Law & Company) in 1716. Because France literally did not have enough specie to pay off its debt, Law devised a way to encourage the public to invest their own money and return some of the government bonds. Shares of Law & Company could be 75% purchased with the “billets d’état,” government promissory notes, and the rest with banque notes in exchange for coins; this was called a “debt for equity swap,” and an expansion later absorbed the rest of the bonds. The billets were considered at face value, which was three times their actual value, which added

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10 Ibid., 35.
capital where there was none.\textsuperscript{11} Law insured that the notes were payable “at sight” in coin at the original coin value (meaning any coin clipping would not devalue the paper money).\textsuperscript{12} From this incentive, paper money was traded at 15\% more than the actual face value.\textsuperscript{13} In 1717 the banque notes became accepted as payment for taxes and Law cut the government’s interest rate from 6\% to 4\%.\textsuperscript{14}

Law & Company became nationalized to become the Banque Royale in 1719 and made notes convertible to the \textit{current} coin value.\textsuperscript{15} However, in reality, Law only held a fraction of the value of the banque notes in coins, but continued to allow the printing of more money. The Banque Royale was similar to the national Bank of England in that both collected taxes, printed paper money, lent money, stored the bullion, refined coinage, and funded the debt.\textsuperscript{16} In 1720 Law was named minister of finance by the duke d’Orléans, but by then, investors had begun to doubt the value of their paper money. Centralizing all of these functions made the economy more efficient, but relying so heavily on a single institution that had no reputation or credibility put France’s economy in a precarious situation.

In addition, Law issued stock in a new company called the Compagnie des Indes (the Mississippi Company) that took advantage of France’s land in America. Similar to Law & Company, investors could purchase shares in the Compagnie des Indes with banque notes and government bonds. By 1719 the Compagnie des Indes owned the French trading rights in the Mississippi River, Louisiana, China, East India, and South America, as well as the Senegalese Company. In February of 1720 the Compagnie merged with the Banque Royale; it then had the

\begin{footnotes}
\footnote{11} Durant, \textit{The Age of Voltaire}, 11.
\footnote{13} Tvede, \textit{Business Cycles}, 11.
\footnote{14} Hyde, \textit{John Law}, 91 and 93.
\footnote{15} Ibid., 111.
\end{footnotes}
authority to mint bullion, issue the paper livres, and collect taxes with banque notes. The Compagnie des Indes truly oversaw most of France’s economy and trade with many other countries and valuable commodities.

Although the Compagnie des Indes consisted of monopolies and trading rights of companies around the world, its desirability as an investment primarily rested on the huge benefits that were expected to come out of the Mississippi and Louisiana territory, primarily gold. Law sent thousands of people to travel to America (many of whom were the poorest people or criminals) with the information that gold was plentiful and accessible, but one-third died or came back to France empty-handed. Those who arrived in New Orleans were not greeted with the “new city with eight hundred beautiful houses,” but rather “squalid conditions, rude buildings…and trails leading back into the cover of trees.” Because neither the investors nor Law had actually traveled to the Mississippi territory, they based their speculations on the intriguing Indians who were in France and false assumptions about the New World. The lack of value in the Louisiana territory only added to the deceitfulness of Law’s whole plan.

In addition, there was a secondary stock exchange called the Rue de Quincampoix. This is analogous to the current Wall Street in America, but much more chaotic with stampedes of people shouting and rushing. Here, the people could buy and sell shares. Law originally issued stocks through an initial public offering (IPO), but secondary sales in the Rue de Quincampoix soon allowed the stocks to easily circulate throughout France. Furthermore, investors bought shares on margin and as low as 10% down, so people were able to make more money than they

19 Ibid., 93.
20 Ibid., 112-113.
initially invested; one banker earned 100 million livres while a waiter made 30 million livres. This not only misguided the financiers who were deceived by the vast amount of wealth pouring into the country, but also the individual investors who leveraged themselves way beyond their means. Average people who profited from the Mississippi Company stock trade lavished themselves with expensive art and furniture, luxurious possessions, grand houses, and good-paying jobs during this time of prosperity. People flooded the country with wealth from the amazingly high, yet artificial, stock price. “A coachman who had never even held a gold coin in his hand sold his Mississippi shares at such a profit that he was able to rush off and buy the biggest, most extravagant coach in Paris.” Goods and services flowed in and out of France at a higher rate than anyone could have imagined, especially after the despair France had been in only a couple of years ago. From 1719-1720 France’s economy increased by an astonishing 60%. However, the booming economy was only a spiral of unfulfilled obligations and a multitude of debt.

During this period the economy experienced what is now known as “irrational exuberance” where individuals speculate with illogical optimism and no apparent reason except everyone else believes in the heightened and artificial value which increases the rate of investment. It was not surprising that many people got in on this stock because it was expected to yield 200% per year! The share price escalated from 500 livres per share during the IPO to 18,000 livres per share in 1720, right before people started to lose confidence. In 1719 the value of each stock was 12,000 livres per share which was already 80 times greater than the amount of gold and silver in

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22 Ibid.
the entire country.\textsuperscript{27} Despite this frenzy and the false economic revival, Law did know how to get France on track to a permanent recovery, if only the short term plan had worked as he had anticipated.

During the making of the bubble, Law worked hard to restructure France’s economy by making the tax system more transparent and just, encouraging investment, and investing in the foundations of France’s economy. \textit{A Letter to Mr. Law upon his Arrival in Great Britain} states that Law enhanced France’s economy as he “took away the Toll Bars at the Entrance of Paris, and abolished all those heavy Taxes, with which the Poor were chiefly affected…Actions render’d him extremely dear to the Common People, who publickly called him the Saviour of France.”\textsuperscript{28} This shows how Law ultimately had good intentions for France and wanted to help get the country back on its feet.

Law simplified and reduced taxes, which encouraged spending and prosperity. He made vast strides to end the corruption among the tax collectors. He also divided up large estates that were held by the Church and corporations and encouraged the Church to sell property that it had owned since 1600.\textsuperscript{29} Prohibiting duties on foods and goods within France as well as lowering the interest rate greatly expanded trade by making goods less expensive and money easier to borrow. In addition Law invested in new infrastructure and repairs for roads, bridges, and canals. The government was able to pay for these improvements with the unrealized capital gains from their shares in the Compagnie des Indes.\textsuperscript{30} Unfortunately, the potential gains had no foundation to actually fund infrastructure or sustain a reduction in taxes.

\textsuperscript{27} Durant, \textit{The Age of Voltaire}, 12.
\textsuperscript{28} A Letter to Mr. Law Upon his arrival in Great Britain 16-17
\textsuperscript{29} Durant, \textit{The Age of Voltaire}, 13.
\textsuperscript{30} Ibid.
However, Law’s Système was fundamentally flawed. One of Law’s greatest misconceptions was that the value of stocks and bonds is essentially money. He even went so far as to think that stock/shares are a superior form of currency because they do not increase the money supply. 31 While a growing economy requires the expansion of the money supply as more goods are being produced, Law ignored the dangers of inflation and assumed that his Système would increase the money supply in circulation as the demand for money increased without tying it to the amount of bullion. 32 Law initially promised his clients that the notes were backed with silver and gold, yet he later changed his mind and inflation swiftly became a reality with prices and wages significantly increasing.

However, the worst issue that Law did not address or realize was that the value of the Compagnie des Indes was not accurately reflected in the value of its shares. Investors thought paper money was sound, so they went on a spending frenzy, though technically no one was rich until they realized their capital gains. Law counted on investors to maintain confidence in the Compagnie des Indes until the Louisiana and Mississippi territory could develop and export wealth back to France. He also viewed stocks as a long term investment and the dividends as the short term rate of return; Law erroneously thought the investors felt the same way. An abrupt loss of confidence that occurs so often at the peak of bubbles can take a profitable idea and bankrupt it, especially if the endeavor is financed with short term funding, such as stocks. 33 Law also lied to the investors about the prospects of France’s colony in America; he described it as a land full of gold and welcoming people when in reality it was a lot of unconquered wilderness. “Hopes of gold or precious stones to be mined from the colonial soil proved illusory, though

31 Garber, Famous First Bubbles, 99.
32 Tvede, Business Cycles, 6.
33 Garber, Famous First Bubbles, 106.
Law himself had entertained that dream.”34 There was very little substance behind the Mississippi Company or the paper money circulating throughout France, once Law decided not to peg paper money to the amount of silver. Richard Cantillon, an Irish banker who gained 20 million livres from the Mississippi Bubble, later stated that “Money, or the common measure of value, must correspond in fact and reality in terms of land and labor to the articles exchanged for it. Otherwise it would only have an imaginary value.”35 This further portrays how Law was fabricating imaginary value based on unrealized prospects.

During the height of the bubble in December 1719, the duc de Bourbon sold his shares of the Compagnie des Indes for 20 million livres and in the same month the Prince de Conti sold his shares for 14 million livres and took the money from the Banque Royale in coin.36 As he brought in three carriages to carry away the coins, he said “Voila, monsieurs! Your notes, which are ‘payable at sight.’ Now, do you see them? Well then, hand over the coins!” 37 This ignited others to cash in their paper money, hoard coins, or even take the money out of the country, which significantly decreased the specie money supply. When Law restricted the amount of specie individuals could possess, more and more demanded their coins in exchange for the paper money. Scared that the bank did not have enough specie to back all of the banque notes, everyone rushed to the bank to discover exactly what they had feared, a perfect example of a self-fulfilling prophecy. People became so anxious that in July of 1720, the banque did not redeem any note greater than a ten in exchange for coins. Riots ensued as people tried to redeem their notes for silver and on one day ten women were trampled to death in all of the chaos.38

34 Durant, The Age of Voltaire, 14.
36 Durant, The Age of Voltaire, 14.
37 Tvede, Business Cycles, 19.
38 Durant, The Age of Voltaire, 15.
in 1720, the duke d’Orléans prohibited the use of coins, and individuals were not allowed to have more the 500 livres worth of coins; this was very counterintuitive because it gave further reason to believe that the government did not have enough metal to back everyone’s notes, which was true.\(^{39}\) Desperately trying to encourage the use of paper notes, the duke printed an additional 1.5 billion livres which further spurred inflation.\(^{40}\)

Since the bank and the Compagnie des Indes had merged early in 1720, they fell together. In May 1720 when the duke and Law realized printing more money was not putting a stop to the falling stock price, they decided to devalue notes by half, but recalled that action a week later.\(^{41}\) They also closed the bank to stop a run on it. While Law and the duke valiantly tried to stabilize the stock price and the bank, their actions confused investors, which made the situation worse. The duke d’Orléans then dismissed Law and brought back in D’Aguesseau, former chancellor, to help. He re-opened the banque and allowed people to turn in their notes for a new kind of metal, copper.\(^{42}\) However the government still enforced that notes between 1,000 to 10,000 livres must be used to buy bonds, invest in the Compagnie des Indes, or be deposited in back accounts. These strict rules and new, hurried changes would clearly make any investor skeptical of the liquidity of the banque.

As the stock price plummeted and thousands of people lost all of their investments, chaos and revolt against Law and duke d’Orléans emerged. Because so many had bought the shares on credit as well as expensive goods, when the stock price collapsed the entire economy fell into a spiral of debt and instant devastation. Ultimately the Banque Royale became nearly worthless and then closed. France shied away from paper money and did not establish a new central bank.


\(^{40}\) Ibid.

\(^{41}\) Tvede, *Business Cycles*, 22.

\(^{42}\) Ibid.
until 1801 or a stock exchange until 1851. The bubble also reduced the influence of the Parlement of Paris. When Law and the duke d’Oréans wished to expand the trading rights of the Compagnie des Indes, Parlement refused the initiative, so the duke exiled members of Parlement to Pontoise. The animosity between the monarchy and Parlement had been growing since Parlement refused to authorize the Compagnie des Indes shares to be purchased with billets d’état, partly because the interest on the billets supported members of Parlement. After the bubble burst, France returned to some of its old practices such as the Farmers-General which obliterated much of the actually productive and positive aspects of Law’s Système.

The Mississippi Bubble had profound short term impacts on France and the frenzy even spread to Great Britain where the South Sea Bubble quickly followed. “One thing is certain, that so Specious was his System, that even after it had failed here, it was set up and carried on in England and Holland: But as the Managers had neither the Strength to conduct nor the Skill to fit and accommodate it to the different Constitutions of those Countries, it fell in pieces sooner there.” Law ignited a contagion of greed that affected many across Europe.

The long term impacts in France were also significant. For a century, France did not trust a stock system or paper money. In 1763 during the Seven Years War, part of Mississippi territory was given to England and Spain, and France lost part of its stronghold in America. The circumstances that France faced after the crash were minor factors in leading up to the French Revolution 70 years later. Because France went back to the financial system of the 17th century, the country’s long-term financial system worsened.

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43 Neal, “I Am Not a Master of Events,” 147.
44 Tvede, Business Cycles, 23.
45 Hyde, John Law, 114-115.
46 Roberts, A Letter to Mr. Law, 20-21.
John Law’s Système was the first to experiment with paper money in a stock market; it set a precedent for stock bubbles and how governments react. Law sacrificed inflation for a low unemployment rate and a lively economy, but that quickly backfired. However, Law’s ideas could have created a prosperous economy if the investments had been better represented to the public and backed with actual value. Still, many powerful financiers are certain that they are smarter than everyone else and pioneer their own models, but can be susceptible to losing common sense and perspective. The most significant contribution of John Law and the Mississippi Bubble is paper money, which affects everyone’s life today. Although it took France a while to regain its confidence in paper money, now most everyone uses the means of exchange that Law popularized. If Law had succeeded with his Système, France would have had a steadier path toward reform rather than the unstable economy that persisted throughout the 18th century and exploded into a violently abrupt revolution.
Bibliography


