

Second Vice President's Letter

John Law – The Scottish Gambler Economist

by Howard Sinder

When you think about Scotsmen who have shaped our modern world, one should consider John Law as one of the greatest. He is best known for causing the Mississippi Bubble by creating money out of thin air. Born in Edinburgh in 1671 he was, in no particular order, an economist, gambler, banker, convicted murderer, royal adviser, rake and adventurer – just the sort of fellow who would have succeeded as one of Wall Street's "Masters of the Universe."

Law's economic fame rests on two major ideas; the scarcity theory of value and the real bills doctrine of money. The latter he explained by use of his famous "water-diamond" paradox, namely, that water, which has great use-value, has no exchange-value, while the opposite is true for diamonds.

Law's "Real Bills Doctrine" of money basically stated that money was credit and, therefore, determined by the needs of trade. Essentially, the amount of money in existence is determined by the supply of credit in the economy.

In the early 18th century, the economy of France was in shambles, making it fertile ground for Law's monetary and economic ideas. Law came to France in 1714, having escaped from jail in London, and renewed his acquaintance with the nephew of King Louis XIV, the Duke of Orleans. In 1715, the duke became Regent of France after the king's death. The Regent served as ruler while the heir to the throne, 5-year-old Louis XV, was still a minor. The duke recalled Law's financial prowess and sought his advice and assistance in straightening out France's financial mess which had been created by years of reckless spending under Louis XIV.

In 1716 Law convinced the French government to let him open a bank, the Bank Generale, with the rights to issue paper money, or bank notes. The paper notes

would be supported by the bank's assets of gold and silver, and would circulate as a medium of exchange. Law believed that paper notes would increase the money in circulation, which, in turn, would increase commerce. These conditions would help revitalize and rehabilitate the finances of the French government.

In August 1717, he organized the Compagnie d'Occident (Company of the West) to which the French government gave the control of trade between France and its Louisiana and Canadian colonies. The colony stretched for 3,000 miles from the mouth of the Mississippi River to parts of Canada. It included the present-day states that hug the river: Louisiana, Mississippi, Arkansas, Missouri, Illinois, Iowa, Wisconsin, and Minnesota. The colony of Louisiana's connection to the Mississippi River gave rise to the company's more popular name, The Mississippi Company.

Law's company had exclusive trading privileges in the territory for 25 years; it could appoint its own governor and officers in the colony and make land grants to potential developers. In turn the company accepted the responsibility of transporting 6,000 settlers and 3,000 slaves to the colony before expiration of its charter.

The scheme to finance the initial operations of the Mississippi Company was simple. Law would raise the money by selling shares for cash, and, more importantly, to the French government in exchange for state bonds. Law accepted a low interest rate on the bonds, which helped France's finances. More importantly for Law, the interest on the bonds enabled him to secure a stable cash flow for his company.

It turns out that the Mississippi Company was a small part of a much grander empire he was about to create. In September 1718 the company acquired the monopoly in tobacco trading with Africa. In January, 1719, Law's Bank Generale was taken over by the French government, and was renamed the Bank Royale. Law remained in charge, and the crown guaranteed the bank's note issue. In May he obtained control of the companies trading with China and the East Indies. He

renamed his entire business interest the Compagnie des Indes, but most people still called it the Mississippi Company. In effect, Law now controlled all trade between France and the rest of the world outside of Europe.

The company next purchased the right to mint new coins for France, and by October it had purchased the right to collect most French taxes. In January 1720, Law became both the Controller General and the Superintendent General of Finance. Law now controlled all of France's finances, money creation, and the company that handled all of France's foreign trade and colonial development. Furthermore, by holding much of the French government's debt, he had created a stable source of income for future business ventures. He had become the most powerful man in France.

Law paid for these activities and privileges by issuing additional shares in the company. These shares could be paid for with bank notes (from his bank) or with government debt.

The value of shares in the Mississippi Company rose dramatically as Law's empire expanded. Investors from across France and Europe eagerly played in this new stock market. The financial district in Paris often became so congested with investors that soldiers would be sent in to maintain order. Shares in the Mississippi Company started at around 500 livres tournois (the French unit of account at the time) per share in January 1719. By December 1719, share prices had reached 10,000 livres, an increase of 1900 percent in just under a year. The market became so seductive that people from the working class began investing whatever small sums they could scrape together.

The weak spot in Law's scheme was his willingness to issue more bank notes to fund purchases of shares in the company. Stock prices began falling in January 1720 as some investors sold shares to turn their capital gains into gold coin. To stop the sell-off, Law restricted any shareholder payment in gold to less than 100 livres. To help him, the French government made the paper notes of the Bank Royale legal tender, which meant that they could be used to pay taxes and settle

debts. The company was trying to get people to accept the paper notes rather than gold. The bank subsequently promised to exchange its notes for shares in the company at the going market price of 10,000 livres. This attempt to turn stock shares into money resulted in a rapid doubling of the French money supply which led to inflation taking off. By January 1720, inflation reached a monthly rate of 23 percent or 1200 percent per annum.

By September 1720 the price of shares in the company had fallen to 2,000 livres and to 1,000 by December. By September 1721 share prices had dropped to 500 livres, just where they had been at the beginning.

The story of John Law and the Mississippi Company is as intriguing as any modern financial disaster. In the end, many of the new millionaires were financially destroyed. So was France. It took 80 years before France would again introduce paper money into its economy.

Plus ca change, plus plus c'est la meme chose.