

Law's System: a lesson in bubbles

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In the aftermath of the death of Louis XIV, France is weighed down by debt. The Scotsman John Law proposes a bold reform to the Regent: to create a bank issuing paper money, and then a trading company entrusted with colonial trade and the management of the public debt, whose shares would be exchanged for debt securities. Between 1716 and 1720, Law's "System" enjoys a spectacular rise, followed by a brutal collapse.¹

At the height of the speculation, the company's shares reach dizzying prices, and Paris experiences a financial fever without precedent. Then confidence turns. Holders seek to convert their notes and shares into coin or real assets, coercive measures multiply, and the System collapses. Law leaves France. Considerable fortunes are destroyed, while others are made by those who sold in time.

The Protestant bankers took part in the System in various ways, some profiting from the rise, others losing by it. Historians note that several of them, taught by the experience of earlier crises, converted their gains into safer assets before the collapse.² In any event, the episode left in France a lasting distrust of paper money and of large banks, which would delay the creation of a central bank until the end of the following century.

For Geneva's financial culture, Law's System served as a warning. It illustrated the dangers of speculation, of indebtedness and of blind confidence in the promises of a ruling power. The prudence attributed to Genevan bankers is nourished by such experiences.

Worked example. An investor buys a share in the company in 1719 at a price of 5,000 livres, borrowing 4,000 livres. At the peak of the bubble the share is worth 10,000 livres: he has multiplied his own stake sixfold. A few months later the share is worth only 2,000 livres: he has lost his stake of 1,000 livres and still owes 2,000 livres to his lender. Leverage, which amplifies gains on the way up, amplifies losses on the way down. The

figures are fictitious; they do not reproduce the exact historical prices of the company's shares.

1 Notes

1. Wikipedia (en), “John Law (economist)”: Banque générale authorised in 1716 (May), Compagnie d'Occident (1717), bank bought by the state and renamed Banque royale (1718), Compagnie des Indes (1719, absorbing the bank in February 1720); Law Controller-General of Finances on 5 January 1720, dismissed on 29 May 1720 after the runaway rise in prices and the run on the bank; departure for Brussels on 22 December 1720. ↩
2. Wikipédia (fr), art. “Système de Law”: Banque générale authorised in 1716 on the model of the Bank of England, Compagnie d'Occident in 1717 with the monopoly of Louisiana, Banque royale in 1718 whose notes were accepted in payment of taxes, peak and then collapse in 1720 — Law becomes Controller-General of Finances in January and mass withdrawals begin as early as July — and the “visa” of 1721 covering 2.5 billion livres of paper held by 511,000 depositors; speculation is concentrated in the rue Quincampoix, where a riot leaves seventeen dead; the public debt falls temporarily from 2.8 to 1.7 billion livres, at the price of a lasting distrust of paper money. ↩

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