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Reversals of Fortune in the Tea Industry

Part IX: John Law's Scheme to Catapult France to the Forefront



DIVIDEND DAY AT THE BANK OF ENGLAND

“When John Law plied his financial wizardry in eighteenth century France, dissolving the national debt and creating fortunes for anyone who invested in his scheme, the rest of Europe looked on in envy. Known as the *Mississippi Bubble*, Law’s complex manipulations of shares and dividends would eventually destroy the entire banking system that he helped establish. In an effort to copy France’s early success, England created a similar scheme under the auspices of the *South Sea Company*. When both bubbles burst simultaneously, the ensuing financial disaster evaporated fortunes overnight and sparked bank runs. But, unlike the *Royal Bank of France*, the *Bank of England* had avoided entanglement with the speculative frenzy and was able to survive the onslaught. The contrast ensured that Great Britain, rather than France, would lead Europe’s drive toward global expansion and international trade.

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To allow our employees to enjoy a four-day workweek during the month of August, Upton Tea Imports will be closed on Fridays from August 1 thru August 29. Orders received after 2:00 PM on Thursdays will be shipped promptly on Monday.

Reversals of Fortune in the Tea Industry, Part IX

We noted in Part VIII of our series that John Law's founding of the *Royal Bank of France* was fundamental in reinstating financial stability after the reign of Louis XIV. England's establishment of a national bank years earlier had given France a mandate to do the same.

John Law was uniquely gifted. With a combination of bold self-confidence, a brilliant mathematical mind, and uncanny charisma, Law mesmerized Europe with his financial wizardry, which introduced many models of finance that were yet unknown at the time. John Kenneth Galbraith would later state that Law "showed, perhaps better than any man since, what a bank could do with and to money."

Fundamental to Law's success was the introduction of a stable paper currency, backed by specie of fixed weight. By contrast, gold and silver coins of the era were often *clipped* (shaved of small amounts of metal) as they passed hands. Furthermore, many began with questionable weight due to chicanery by goldsmiths. Most significantly, coins were frequently devalued (reissued at lower weights) in an effort to lower the crown's debts. Law theorized that by backing paper currency with fixed-weight specie, it would actually be more valuable than coins of the same denomination, since no gain could be had from clipping a bank note, and devaluation would be precluded by their fixed-weight backing.

Earlier attempts to issue paper currency in France had failed because the public simply did not trust paper. Many merchants refused to accept paper currency, and only traded in specie. Law's currency was treated with the same skepticism when it was first released. However, with repeated exchanges for fixed-weight coins, Law's notes finally won acceptance. His theory about the preference for his

currency was proven, and paper currency soon traded at a premium to coins. This eventually stemmed the tide of currency redemptions. Within months the rate of redemption was so low that additional currency could be safely circulated. This increase in the money supply gave a breath of fresh air to the suffocating French economy.

Law's early success startled England, and many were suggesting that France would eventually take the lead in the struggle for supremacy in international trade — precisely what Law was promising to anyone who would listen.

Within two years, he had brought stability to the formerly bankrupt economy of France, and soon he would ply his talents on grander schemes. In a letter to the regent he boasted, "The bank is not the only nor the greatest of my ideas. I will produce a work that will surprise Europe by the changes it will produce in France's favour." The work to which Law was referring was the formation of an enterprise called the *Mississippi Company* in 1719. It was, in effect, the first *holding company*, similar in concept to Warren Buffett's *Berkshire Hathaway*. As we shall see, however, there are more similarities between John Law and Charles Ponzi than there are between John Law and Warren Buffett.

There are conflicting accounts of precisely how Law's company was structured. Its first acquisition was the nearly defunct *Compagnie de l'Occident* (which was chartered to explore and exploit French territories in North America). It soon enveloped the *East Indies* equivalent and by 1720 controlled the *Royal Bank of France*, successor to the *General Bank* that Law had founded a few years prior.

In effect, Law was managing the financial affairs and major enterprise of all France. Regent d'Orleans was dazzled by Law's magic, but he was disinterested in any of the details. Ostensibly managing the interests of the infant king, Louis XV, the regent naively saw

in Law's schemes a way to raise unlimited funds for the throne.

To quote Janet Gleeson (*Millionaire — The Philanderer, Gambler and Duelist who Invented Modern France*): [p. 121]

The idea that would rock the world and immortalize its inventor seemed innocuous enough. Law's rapacious eye had focused on the wealth promised by the Indies, Africa, and the Americas, and he wanted to form an overseas trading company to exploit it. The Italians, the Spanish, the Portuguese, the Dutch, and the English had all reaped immense fortunes from their fleets laden with silk, ebony, ivory, lacquer, coffee, tea, chocolate, spices, gold, silver, porcelain, and myriad other luxurious and lucrative cargoes. Now, said Law, France should share the harvest.

Just as William Patterson had gambled his legacy on the *Darien Scheme*, so did John Law risk all on the Mississippi Company. Both schemes ended in complete failure, with hopes for huge profits transformed into financial ruin. But failure would only come after a financial extravaganza that Norman Angell (*The Story of Money*) referred to as "juggle[ing] like a master magician with shares, premiums, installments and issues."

Law's original plan was simple enough. The Mississippi Company was granted sole rights to exploit mineral wealth and other assets of the Louisiana Territory in North America, and would enjoy exclusive trading rights as well. An initial issue of 200,000 bonds, valued at 500 livres each, raised 100 million livres (roughly \$11 million).

The Louisiana Territory was largely unexplored, and the extent of its wealth was yet unproven. There was reluctance by most to put money into such a speculative venture. To stimulate interest in the Mississippi bonds, unemployed workers were hired to dress up as miners and march through the streets of Paris. They carried lanterns, picks, and shovels, as though they were on their way to America, where mountains of gold and precious jewels awaited. But the bonds still languished, and were trading below par.

Finally, Law stated publicly that he would personally guarantee the value of bonds, offering to repurchase them at par from anyone who invested and later decided to sell. At the same time he allowed the Mississippi bonds to be purchased on margin for twenty percent of par. Suddenly the reluctance to purchase Mississippi shares reversed direction and there was a stampede to buy. The 200,000 bonds were suddenly sold out.

John Francis (*History of the Bank of England*) described the ensuing weeks as follows: [p. 105]

Fifty thousand new shares were issued at 550 livres each, and they immediately rose to 1000. ... 300,000 applications were made for 50,000 shares; and the destiny of an empire, remarkable for its national hauteur, seemed in the hands of John Law, the son of a Scottish jeweler. Advantage was taken of this eagerness. 300,000 new shares were issued at 5000 livres each, and the Regent availed himself of the popular excitement to pay off the national debt. ... A rage for shares infatuated every rank. The price reached 10,000 livres in September, [1719]... . A few hours often witnessed an alteration of the price of ten, twenty, and thirty per cent. A servant who was sent by his master to sell two hundred and fifty shares, found the value had risen sufficiently to enable him to make £20,000 sterling by the difference, with which he departed.

The sudden wealth that was available to anyone who purchased Mississippi shares only accelerated the mania. Additional currency had to be printed to fuel the firestorm economy, and inevitably there was far more paper currency in circulation than specie could possibly back.

As with most bubbles, only a few got out at the peak, and many were still clamoring for shares as the bubble was about to burst. Those who "escaped" at the apex managed to drain off an estimated half billion livres from the bank before the hysteria for Mississippi shares began to falter. Soon, the blind faith in the ever-increasing value of Mississippi shares was being replaced by sober reality. The era that coined the term *millionaire* was quickly coming to a close. Soon loans at 2% interest,

using Mississippi shares as collateral, would be uncollectable.

Doubts turned to panic when the truth about the struggling colony of New Orleans began to reach Paris; there were no mountains of gold and giant emeralds to be had. In fact, the colony was struggling to survive. As faith in Mississippi shares dwindled, so did faith in Law's paper currency.

Law eventually threw all of his chips into the pot and made a desperate attempt to bluff his audience. To address the erosion of confidence in the Mississippi Company, he declared a dividend of 200 livres per year on Mississippi bonds, though there was only red ink throughout the Company. It was too little, too late, and the subsequent actions only accelerated the fall. The paper currency which was once sworn to be fully backed by specie of full value was suddenly devalued by 50%.

This desperate, last-minute attempt to restore confidence in the devalued currency and declining Mississippi shares only added to the panic. Huge piles of stock certificates and bank notes were set ablaze, supposedly to convince the public that the excesses of both were being purged. As onlookers saw shares and notes going up in smoke, the ill conceived demonstration only added to the panic.

By this time Law's life was not worth one share of Mississippi stock. He fled for his life, leaving his wife and daughter in Paris, along with all of the fortune which he had amassed in the heady years of his scheme.

The Louisiana Territory would eventually be sold to the U.S. in 1803. Including the cancellation of France's debt to the U.S., the entire area sold for approximately \$23 million. Some believe that since they were unable to properly defend the territory, they might as well sell it to a country that was capable of keeping it from Great Britain.

Although Great Britain's South Sea bubble paralleled that of France, at precisely the same time, the outcome was much less severe. France's *Banque Royale* collapsed, along with Law's currency and the Mississippi Company. It would be nearly a century for the *Banque de France* to once again issue a national currency and capture the trust of the French people.

Charles Mackay (*Extraordinary Popular Delusions and the Madness of Crowds*, published in 1841) attributes the survival of the Bank of England in the aftermath of the South Sea bubble to the strength of her constitutional government. In contrast, there were no checks



and balances to prevent John Law and Regent d'Orleans from plundering the potential wealth of France.

France would still be a formidable opponent, and there were frequent territorial skirmishes between France and Great Britain throughout the eighteenth century. The survival of the Bank of England was the trump card that gave Great Britain the financial strength to triumph. And for the next century *Rule Britannia* would echo throughout Asia. Our series on *Reversals of Fortune in the Tea Industry* will continue in the next issue of the *Upton Tea Quarterly*.