

The History of Financial Crises – Lecture 2 Study Guide

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Lecture 2: John Law, the Mississippi Bubble, and the South Sea Bubble

1) John Law's Early Ideas in Scotland (1705)

- **Context:** Scotland in 1705 was poor, underdeveloped, and financially weak compared to England.
 - **Law's proposal:** Creation of a **land bank**.
 - **Assets:** loans secured by land.
 - **Liabilities:** paper money.
 - **Rationale:**
 - Scotland had **land but little capital**.
 - Paper money backed by land could **expand credit**, fuel growth, and attract immigrants.
 - Paper could substitute for costly imports of silver/gold.
 - **Comparison:** Similar proposals later in **colonial America** (e.g., Benjamin Franklin in Pennsylvania).
 - **Outcome:** Rejected in Scotland, but idea was **credible, not crazy** – rooted in the logic of bootstrapping poor economies.
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2) Law's Broader Insight

- **Government–bank partnerships:**
 - Sovereigns often destroyed banks by defaulting.
 - Aligning the bank with sovereign interests (e.g., lending to crown, collecting taxes) made default less likely.
 - If bank liabilities were partly backed by **sovereign tax revenues**, confidence

increased.

- **Principle: A mutualistic partnership** could stabilize both sovereign finance and the banking institution.
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3) Law in France: The Mississippi Scheme

- Law creates a **grand system**:
- Monopoly joint-stock company controlling **Louisiana land rights, Canada fur trade, French tax collection, and colonial trade**.
- A **bank** issuing legal-tender paper money.
- Consolidation of France's sovereign debt into the company.
- **Innovations**:
- **Installment plans** for investors → allowed broad participation with limited upfront cash.
- **Taxes payable only in paper** → boosted demand for notes.
- **Government ownership & backing** of the bank.

Strengths

- Complementarities among debt holding, tax collection, banking, and trade monopolies.
- Potential for **sustainable valuations** (share prices of ~5,000 plausible with reasonable assumptions).

Weaknesses

- **Overcentralization**: eliminated dissent and market discipline.
- **Removed specie convertibility** of notes (1719).
- **Overissuance of money** to sustain inflated share prices → inflation doubled price levels.
- Reliance on installment plan forced Law to **peg share prices** to keep investors contributing.
- Collapse followed when confidence in paper money broke.

Result: Law fled France; the Mississippi Bubble collapsed.

Historians' verdict: Could have survived at more moderate valuations, but **excessive ambition + money printing** doomed it.

4) The South Sea Bubble (Britain, 1711–1720)

- **Background:**

- Britain in near-continuous war with France (1688–1815) → heavy public debt.
- South Sea Company (1711, Tory-backed) created to **swap sovereign debt for equity**, similar to the Whig-backed Bank of England (1694).
- Nominal monopoly on Spanish-American trade, but rights were mostly worthless.
- **Core function:** Consolidation of **fragmented sovereign debt** into homogeneous, more liquid, longer-term debt.

Why it Worked

- Increased **liquidity** (homogenized debt easier to trade).
- Reduced **default risk** (powerful insiders, sovereign partnership, and legalized bribes created strong commitment not to default).
- Government profited: swapped £1m in heterogeneous debt for ~£900k in consolidated debt.

The Bubble

- Shares paid for using government debt.
- Demand stoked by:
 - Bribes to politicians.
 - Influx of capital after Mississippi collapse.
 - Speculation by uninformed outsiders.
- **Insiders (e.g., Hoare's Bank):** bought early, sold near the top.
- **Outsiders:** extrapolated rising prices, bought late, suffered losses.
- Prices soared, then collapsed back toward ~200.

Consequences:

- Unlike France, Britain's broader financial system remained resilient.
 - The South Sea bubble was a **speculative mania with limited systemic damage**.
 - Highlighted divergence of **informed vs. uninformed investors**.
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5) England vs. Scotland Banking Systems

- **England/Wales:**
 - Bank of England monopoly (1694–1820s).
 - Small, fragmented private banks.
 - Restricted credit, frequent instability.
 - **Scotland:**
 - Multiple chartered and free-entry banks.
 - Innovations: note clearing, interest-bearing deposits, lines of credit, collateral registration.
 - Greater stability: bank failure rate **4x lower** than England's (1809–1830).
 - **Interpretation:**
 - Sovereign prioritized its **own financing** in England (Bank of England monopoly).
 - In Scotland, allowed broader banking freedom as part of political bargain (loss of Scottish Parliament in 1707).
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6) Key Concept: Calomiris' Law of Banking

*A sovereign will only allow banks to serve private credit needs **after resolving its own fiscal survival risks**.*

- *If sovereign is desperate → banks are chartered primarily to serve the **state's funding needs**.*
 - *Only after stability is achieved → banks allowed to serve **private credit markets**.*
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7) Modern Parallels

- **Emerging markets (1980s–2000s):** Similar state–elite partnerships (e.g., Mexico’s “six families,” Korean chaebols).
 - Investors recognize equilibrium: banks serve sovereign interests first, private credit second.
 - **Lesson:** Political equilibrium shapes banking design more than abstract economics.
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8) Key Takeaways

- John Law’s schemes showed **creativity and vision** but collapsed from overreach and lack of discipline.
 - The South Sea Bubble was **sustained by politics and speculation**, but did not cripple Britain’s financial rise.
 - Scotland’s freer, innovative banking system outperformed England’s monopoly-bound system.
 - **War and sovereign survival** explain divergent financial policies.
 - Crises often arise from **adaptive strategies**, not just mistakes.
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9) Review Questions

1. What was John Law’s original land bank proposal, and why was it attractive for poor economies?
2. How did Law’s system in France integrate tax collection, debt restructuring, trade monopolies, and banking?
3. Why did the Mississippi Bubble collapse, and could it have been sustainable at lower valuations?
4. What explains the political creation of the South Sea Company and its role in debt consolidation?

5. How did insider vs. outsider behavior differ during the South Sea Bubble?
 6. Why was Scotland's banking system more innovative and stable than England's?
 7. What does "Calomiris' Law of Banking" imply about financial development in risky sovereign contexts?
 8. How do modern emerging markets echo the dynamics of early modern sovereign-bank partnerships?
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