STEUART V. LAW
A COMPARISON ON NATIONAL DEBT AND THE CREATION OF MONEY

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John Law's name will always be associated with the collapse of the Mississippi System. Steffen Torp, in this analysis, examines the writings of Sir James Steuart, who contended that the collapse was not due to any fundamental flaw with Law's theory but with its mis-application in practice.

1. Introduction

John Law's (1671-1729) reputation as a monetary theorist has fluctuated between being "...at the front rank of monetary theorists of all time" and a "...mixture of swindler and prophet" (Schumpeter 1954: 295; Marx 1992). Such differing views are mainly the result of remembering John Law either as the author of one of the biggest financial booms in history, the Mississippi System of 1716-1720, or for his economic theories and early advocacy of paper money.

To better shed light on the early advocates of paper currency, and on John Law himself, this paper will discuss, and critique John Law's theories and policies through the words of one of John Law's younger peers – Sir James Steuart (1730-80). Steuart was a fellow Scotsman who, like Law, had to flee Britain,[1] and spent approximately half of his life travelling around the continent. Steuart followed in the trails of Law, through the Netherlands, France, Germany, Italy – and also spent some years in Spain. In France he saw the legacy of John Law's system, still sending shivers down the spine of French financiers, and became fully acquainted with the story of Law's financial adventures. Having seen both the poor state of the Scottish economy with much unemployment, and witnessed the famine of Andalusia, he followed up on Law's arguments for introducing paper currency.

[1] Not because he was a murderer, like Law, but because of his political affiliations in supporting the Jacobites in the British revolution.

Although the similarities between the circumstances of these two men are striking, their personalities appear widely different. This becomes apparent by comparing the style of *Money and Trade* v. *An Inquiry into the Principles of Political Oeconomy*. While Law spent (probably) not more than a year on his proposal, Steuart worked on his inquiry for around 18 years (Hutchinson 1988). Law is quick to draw general principles of banking, interest rates, the quantity theory of money, and finance. Steuart merely attempts at scraping together some principles which he believes hold under slightly different circumstances, and is always cautious to put every principle into its right context, and advise the reader not to infer any *Systèmes*, that are "...mere conceits; they mislead the understanding, and efface the path to truth" (Steuart 1767: Book I, Preface).

Nevertheless, despite differences in style and elegance, their conclusions and remedies for the economic problems of their age, remains largely the same. Steuart however, has the advantage of critiquing Law's policies in retrospect, and from a distance.

This essay will start by outlining some of the policy recommendations of John Law, in his *Money and Trade,* and some of his later essays. This is to familiarise the reader with his politics, to create a foundation for understanding the similarities between his proposals, and those of Steuart – but also to see his later adventures in a better light. Section two will present Steuarts propositions and principles on the same subjects, to create a foundation for part three, which discusses Law's Mississippi System, as the first complete system of paper money in modern history. This will be critiqued through the writings and theories of Steuart, mirrored to those of Law, to conclude on some aspects of pre-classical monetary theory that is too often forgotten.

2. The First Proposal For Expansionary Monetary Policy

> "If Money were given to a People in greater Quantity than there was a Demand for, Money would fall in its value; but if only given equal to the Demand, it will not fall in value" (Law 1705: 117).

In *Essay on a Land Bank* (1704) and *Money and Trade* (1705), the theme of Law's propositions was that Scotland had a high (involuntary) unemployment rate, due to a lack of money in circulation (silver), which made the economy function on less than maximum capacity, both because of the unemployment and because of the high interest rate that follows from a scarce supply of money. In the early 18th

century, there were many propositions for a system of a land bank, wherein paper money could be issued, secured against the stable[2] value of land.

Several 20th century observers have applauded Law's visions, and his clear grasp of the concepts of money and value (Murphy 1997; Schumpeter 1954; Wassermann & Beach 1934). As can be seen from the previous quotation, he saw the importance of the demand for money in determining inflation. And more like an early Keynesian, he argued that raising the supply of money would give a boost to trade, by both employing more people, and lowering the rate of interest:

> "So far as they [the bank managers] lend they add to the Money, which brings a Profit to the Country, by imploying more People, and extending Trade; They add to the money to be lent, whereby it is easier borrowed, and at less use" (Law 1705: 37).

There are few, if any, 17th and 18th century economists who surpass John Law in crisp theorising on money and value. As a matter of fact, not until the demise of the American gold standard in 1971, did the modern world fully complete Law's transition away from a currency of pure intrinsic value.

Law's system was inherently anti-inflationist from the beginning. The advocacy of a land bank was precisely to promote a more stable currency, which was more in line with actual demand for money. Moreover, he was aware[3] of the risk of oversubscribing the capital of the banks, and appreciated that the safest bank was that which had all collateral readily available, for all subscribed notes. What later led to his system's failure was his clear grasp of how bank deposits created credit, which was lent on the security of the deposits multiple times over, so that in the end, the security of the credit was the credit itself, and he believed that the supply of money could thus never surpass the demand for it. However, he considered the hazard of default to be outweighed by the huge benefits this creation of money would bring to the economy: "The certain good it does, will more than ballance the hazard, tho once in two or three years it failed in payment" (ibid 38). When Law had to flee Scotland, without having set up a land bank, he spent the following years stretching his ideas to new theoretical lengths. Between 1705 and 1716 he wrote a number of pamphlets and letters in which he abandoned land as the basis for monetary value and proposed that all commercial credit could be utilized for security. He submitted a memorial entitled *Plano per lo Stabilimento della Banca a Torino* in Italy, where he proposed a state-run bank in which the reserves should consist of some idle cash, the funds of the state and

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[2] At least more stable than silver, which was being imported in abundance from Spanish America (ibid: 71).

[3] Law could have been labelled a good 20th century monetarist in this context.

crown, including taxes, and the private deposits of people (Wasserman & Beach 1934). The rules of credit, reserve, and interest for this bank were extremely conservative, in accordance with Law's recommendations. As this paper, and Steuart will show, Law's systems never defaulted because of a lack of security.

The theoretical leap from paper money based on the value of land, to paper money based on credit and state funds, to paper money based on commercial paper, did not seem too big for Law. Thus over 10 years, he effortlessly transferred his system, that was initially based on the contemporarily acceptable land bank, all the way to the complete Mississippi System.

> "Of what use does the king make of this new credit? He only lends it to a trading company, into which all the materials of trade in the kingdom fall successively, and are amassed into one. The whole nation becomes a body of traders, who have for the cash the royal bank, in which by consequense all the commerce, money, and merchandise re-unite" (Law, cited in Wasserman & Beach 1934).

Law got the opportunity to practice his system in France between 1716 and 1720. His project started as a conservative bank, but later took on the whole economy. This will be discussed further in part 3.

3. Steuart-Pragmatic Economics

While Law suffers in the history of monetary thought because of his experiments, Steuart suffers because of his unwillingness to simplify, or model, the subject of economics. Moreover, both of these are examples of applied economics; where Law outlines and executes his theories, Steuart discusses them at length, giving examples from situations he has encountered on his travels across Western Europe, and is careful to always set in context, critically examine, and let the reader know how a policy that has worked in one paradigm, might not do so in another. From his experience, he then draws up what he believes to be general principles that any statesman should adhere to. *Principles of Political Oeconomy* thus builds a bridge between the pre-classicals and Keynes, in focusing on the problem of unemployment and pragmatic disequilibrium economics, while at the same time bringing in the force of *self interest* as the natural force of economics – only 9 years before Adam Smith did in *The Wealth of Nations*.

> "The principle object of this science is to secure a certain fund of subsistence for all the inhabitants, to obviate every circumstances which may render it precarious; to provide every thing necessary for supplying

> the wants of the society, and to employ the inhabitants (supposing them to be fre-men) (...) so as to make their several interests lead them to supply one another with their reciprocal wants" (Steuart 1767: Preface).

Steuart emphasized what was nearly to be forgotten by economists for 150 years – that the prime object of economics is to ensure the well being of every free man in society. He was ahead of Adam Smith in understanding the force of self interest, but instead of relying on an invisible hand, Steuart observes that a statesman is needed from time to time, to steer the course of the people to make optimal use of the *winds of trade.*[4] This also influenced his explanations for booms, and it was because of his disregard for perfect equilibrium economics that he was able to see through Law's system and show how the statesman could have reacted to save the economy when it had gone astray as a result of the psyche of the people.

Steuart seems to be of the laissez-faire school with regard to the optimal rate of interest, which is discussed in Book IV, chap. IV (ibid). Steuart brings in a train of thought, first showing how the rate of interest in a country, depends on the profits of the rich and the industriousness of the merchants and workers,[5] and how *double competition*[6] will bring about the optimal rate of interest for the economy. In chapter V (ibid) he criticises Josiah Child, and the proponents of a low rate of interest, by arguing that a low rate is in fact "the soul of the trade," but that the intervention of the statesman will have "immediate bad effects (...) impossible to be foreseen" (ibid). Instead the statesman should lower the rate of interest by abstaining from borrowing himself, and "discourage borrowing in those who employ their money in prodigality and dissipation." In his reasoning it becomes clear that Steuart believes that if money is spent on luxury for the upper classes, instead of consumption by the lower classes, this will in turn lead to higher interest rates because the marginal propensity to save is higher for the rich than the poor. This in turn will bring the economy to a point where the price of land falls because the rich will want to exploit the higher rate of interest offered on holding money. This again will increase credit and money supply, encouraging spendthrift and industriousness, and lowering the rate of interest. If left to itself the rate of interest will thus fluctuate in a narrow band, according to the amount of property – for "what is money but property, of one kind or other, thrown into circulation?" (Chap VII).

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[4] Self interest. For an in depth discussion on Steuart's view on economics, the force of self interest and the role of the statesman, see Urquhart (1996).

[5] Not unlike, but less detailed, than in Cantillon's *Essai*.

[6] Several sellers and several bidders, ensuring a fair price in relation to supply/demand.

So far, Steuart is coming to the same conclusions as Law 50 years prior. However, Steuart feels a need to distinguish between three types of credit – Private credit, Mercantile credit, and Public credit (Book IV, Part 2). The differences are set out in table 1:

Table 1: The different kinds of credit

	Private	Mercantile	Public
Principle	Money to be lent upon a security of the same value of the credit and its interests.	Established upon the confidence of the lender that the borrower, through his trade, will be able to replace the credit and interest.	The state borrows money, upon condition that it shall not be demandable, but that a certain part shall be annually paid.
Risk of default	Hardly any.	Most precarious	Secure, as long as interest is regularly paid
Attributes	Inseparable from human society	Speculative. Depends on good fortune.	Rests on the stability of certain maxims of government.

Source: Steuart, 1767.

4. Steuart's Critique of Law's System of Public Credit[7]

> “...an ill-concerted system of credit may bring ruin on a nation, although fraud be out of the question: and if a nation be plugned into all the calamities which a public bankruptcy can occassion, it is but a small consolation to be assured of the good intentions of those who were the cause of it” (Steuart 1767: Book IV).

[7]Public credit ≡ Government debt

Steuart spends 9 chapters of his *Principles* on the Mississippi System, of which half are spent justifying the actions of both Law and the Regent. The reason for this is that he sees Law's system as being perfectly devised, according to all laws of money and credit, up until the Regent's "plundering" of 21st May 1720 and in particular the ill-devised repairment of it. Steuart shows how the capital holdings and profits of the Company were actually more than able to support the interests due on the notes, even after being merged with the government's finances, and the Mint. In the chapters building up to his critique of the Mississippi System, he has shown that a mercantile bank, even though its capital is uncertain, is well funded on economic principles because the interest premium offered on the high-risk loans is more than enough to cover the defaults.

Further, the very nature of public credit meant that it could be expanded as long as the profits of the state were larger than the interests due (ibid: Book VI). Therefore, he saw no problem in the fact that the *Banque Royale* seized to guarantee in bullion the value of the paper because for a government-backed bank, only the rate of interest mattered. Steuart quoted Dutot's calculations for the profits of the Company to be at 80 million livres annually.[8] At a rate of interest of 3%, this could answer to a capital of 2,664 million – much more than the consolidated debts of the kingdom.

Steuart thus analyses every part of the undertakings, and links the debts of Louis XIV, which amounted to a net present value of 2,000 million livre and the Duke of Orleans "nobly" rejected to default upon in 1714, fixed at 4%, with the net present value of the Company's profits of 2,664 million livres at an arbitrarily high 3%. What the Duke and Law effectively did, argues Steuart, was nothing more than bring down the rate of interest for the whole country, and as a result "Lands in France (...) sold at 80 and 100 years purchase" (ibid: ch. XXXVI).

The low rate of interest spurred industriousness, and capital requirement rose in the first years. However, it also brought on hyperinflation, which as Steuart observes, was apparently of no concern to the French – who were "absolutely blockheads" who only cared for the denomination of their notes, not their real value. Steuart does not believe that either Law, or the Duke, attempted to defraud the public, but that they believed that demand for money could never rise above a level consistent with maximum output. The latter also seemed to hold until the Regent started to burn notes and issued bank-notes for the townhouse of Paris, instead of the debt previously held. Now the creditors to the state became holders of a bank note, issued by a bank in which the Regent was a debtor, instead of creditors to the townhouse, which was an institution created by jurisdiction.

8 Payable profits from the General Farms, the tobacco trade, tax receipts, the Mint, etc..

This might still have worked out well, had not the Regent started the "absurd operations of changing the denominations of coin and paper" so that the value of the note could be diminished by half every month, while the coin was doubled in value (ibid). This made it apparent to the public that the ministers were toying with their property, so as to raise the value of the coin in the Regent's coffers up to the point where his debt disappeared. It is only after these actions, which took place during the summer of 1720, that Steuart finds it appropriate to use the term *defrauded*. Most of the problems throughout the whole period were, however, due to money illusion.

Steuart proposes that if the government had taken quicker actions during this fatal summer, the value of paper money could have been restored – although severely devalued. The speculation occurring during 1720[9] could take place because the central bank successively depreciated the currency at intervals over the whole summer. Those that bought low and held on to the money until the turbulence ended and the money again became stable on 10th October made a profit, whereas those that ridded themselves of the money when it traded at a discount and had to buy it back when it again recovered its credit, suffered an irrecoverable loss.

If the Regent had ordered all money to be presented to the bank during the fatal summer, and recorded in the books as bearing an interest of 2% to be paid monthly, this would have restored the value of paper money, argues Steuart, because no one would want to sell their notes at a discount. This was consistent with his view that any borrower who never defaults on the interest payment will never lose his line of credit. Instead the danger of default pushed interest upwards.

Throughout the whole account, Steuart talks of Law only in favourable terms. To the very end, he argued that France could have prospered to great richness if only they had implemented certain measures for regulating the actions of the Statesman:

1. It should be established that all changes on the "denominations of paper or coin, were contrary to the aims of good government" (ibid).
2. All stipulations between the King and his creditors should be inviolable.
3. The parliament should remain invested, with exclusive rights to regulation. Both the King and the Parliament should be bound by an oath.

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[9] In which amongst others, Richard Cantillon was a partaker (see Murphy, 1986)

5. Conclusions on Steuart, Law, and Public Credit

This paper has given an account of the first experiment with paper currency devised in modern history. Section one showed how John Law devised his theoretical system of money and credit, and how he was one of the first proponents of creating money from property (in all forms) and credit.

Section two showed one of his successors in political thinking who not only theoretically sanctioned Law's system, but at a time when Law was more unpopular than he has ever been, Steuart argued that Law's actions were both theoretically and contextually sound, but that the public was not ready for such an experiment. The remedies for Law's system, as advocated by Steuart were also discussed.

In 1945, Walter F. Stettner argued in *The Quarterly Journal of Economics* that: “The stupendous rise of the public debt during the present war has aroused concern...over the ability of the nation to cope with its postwar economic problems,” but the debt of the 18th century was much worse; however, instead this rise in debt had supplied “the key to the economic history of Britain and her rapid rise to commercial and industrial supremacy.” Today, every time a country's debt rises out of proportion, Law's failed system seems to be looming in the back of economists’ minds. It is then important, however, not to forget to apply the correct remedies for such failures. Above anything else, Steuart showed how hasty remedies, rather than the system in itself, might produce and economic collapse, far worse than the original problem.

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