THE MISSISSIPI'S BUBBLE

When confidence in a currency collapses

Why bitcoin was revolutionary

Since the development of classical economics, monetary policy has been one of the most debated research topics by both theoreticians and policy makers at a global level. Until the development of the first virtual search engines, however, its fiduciary nature had never been questioned. In other words, a currency by constitution had to be issued by a central authority, such as a central bank, and its validity as a means of payment had to be guaranteed by law.

In January 2009, Satoshi Nakamoto launched a digital currency on the web, intended to undermine these basic principles: bitcoin. Beyond all the technical details, any crypto currency in history has the following characteristic: no centralized authority can determine its value, which on the contrary is determined by the interaction between supply and demand. According to this principle, then the currency is no different from any traded commodity market and this has allowed bitcoin to grow in value by a ratio of one to sixty in just ten years. Unlike all consumer goods, however, money has a unique characteristic, which the early monetarists had already identified; it is not so much its intrinsic value that makes money valuable, but the subjective value that other economic operators attribute to it.

If you buy a pair of shoes in a shop in fact you are buying a good made of well-defined material. Beyond your personal tastes, you will be able to ask for a cash return if the accessory is defective; this is because all of us consumers recognise the existence of a minimum standard of quality, based on objectively demonstrable criteria. If instead you buy a Tesla share on Wall Street and Elon Musk decides to smoke marijuana in an interview, your stock will lose 10% in a few hours, precisely because its value is determined by the mood of thousands of other investors: and for all this there is no universally recognized benchmark at quantitative level.

It may sound like a trivial example, but what you've read is a miniaturized case of the speculative bubble. The story that follows is only more extensive.

The character John Law

When John Law arrived in Paris in the first decade of the 1700s, he had just fled Britain after killing a man in a duel. He had already lost huge sums in gambling in London and had recently published "Money and trade considered": a study of the emerging European banking systems, which set out some of the first guidelines for monetary policymaking. In 1716, the new regent of France, the Duke of Orleans, offered him the opportunity of life: to carry out his ambitious financial plan outlined in his writings. The Scottish author's aim was revolutionary: to replace metallic money entirely with paper money.

Law's theoretical topic was similar to the one presented earlier: not only is the intrinsic value of money irrelevant to the purposes of a trade economy, but its volatile nature is an enormous obstacle to its full development. The discovery of a gold mine can cause its price to skyrocket, causing economic operators not to exchange the currency anymore. Law therefore wanted to ensure that the circulation of money was adapted to the course of market transactions and not to the fluctuation of the precious metal. To do this, however, we needed a central bank able to control the supply of currency and a low-value material that would form the basis of the new currency, such as paper.

Creation of the system

The regent of France, grappling with a monstrous public debt, was desperate enough to entrust the entire finances of the state to Law. In 1716 the Scotsman created the Banque Générale, in charge of managing the entire national monetary supply. The second decisive step in the creation of the Law system was the establishment of the Mississippi Company, which was entrusted with the exclusive right to exploit all of Louisiana's natural resources.

Holders of French debt securities could convert their debt securities into shares of the colonial society. The Scottish economist's bet was twofold: on the one hand, public debt would be converted into private debt in the hands of French citizens, and on the other hand, the purchase of securities would guarantee the gradual disappearance of metallic currency from the national market. For this plan to work, a particular condition had to be met: the company's share price had to rise exponentially, fuelling a climate of euphoria among French taxpayers. Many today would label this phenomenon as a speculative bubble. To secure this scenario, Law promoted a sharp increase in the money supply in this circulation, reinvesting much of this new currency in the purchase of shares.

The bubble

The system was therefore based on a constant rise in investor stock expectations and on a continuous issuance of new currency. However, the two phenomena were closely related: as soon as stock values began to fall, investors would stop transferring resources into the Central Bank's coffers, effectively ending the expansionary monetary policy. The system was therefore too interconnected to stand on its own, and worse still, it could not count on an emergency policy if the stock market collapsed. In short, it was too daring a gamble, even for a brilliant gambler like Law.

The collapse

The system stalled in 1720, and fearing a collapse in the value of the Mississippi Company, Law anticipated a gradual reduction in the number of shares to prevent an inflationary spiral. On the contrary, it obtained a case of financial panic: distrustful, investors tried to dispose of the stocks simultaneously, decreeding the bankruptcy of the whole system. Public debt had been vaporized at the expense of rather large private losses.

Law fled to Venice after resuming his activity as a gambler and was condemned to oblivion for about two centuries, despite the innovative nature of his ideas.

Why trust matters

The case of the Mississippi bubble is interesting because it shows us how a currency does not have a different value from what other economic operators attribute to it. Simply put, the financial fortune accumulated by the wealthiest French financiers through the Law Company irreversibly lost value when a sufficient proportion of investors lost confidence in the system. Law himself tried to anchor the value of his banknotes to French colonial resources, precisely because he was aware that without an adequate material basis it was impossible to inspire security among French taxpayers.

The other interesting lesson is that no system can survive without a contingency plan: the inextricable link between debt management and monetary policy prevented Law from intervening when the bubble burst. In that case, perhaps history would have turned out differently.