

Suggestions for answers

1. *What were the “juros” in the reign of Philip II of Spain? Why were they a safe asset for investment?*

“Juros” were long-term government bonds. They were redeemable (hence subject to interest reduction). The greater part were perpetuals, some were life-annuities. They were marketable. Most of them had their interest serviced from the *encabezamiento* that was a fixed annual contribution from cities to the Crown, decided in the Cortes. Often the local office that paid the coupons was also collecting the taxes for the *encabezamiento*. What was necessary to pay the coupons was withdrawn locally from the *encabezamiento*. Only the surplus was transferred to the central government. Since the taxes were controlled by the cities and influential residents owned the *juros*, the alignment of the interests enhance the safe service of the *juros*.

2. *Some have suggested that when Philip II stopped payments on the loans by Genoese bankers in 1575, that was a standard case of sovereign debt default in which the sovereign defaults on foreign bankers. Comment. (Here, one does not expect a short answer. Take the space your need).*

Wrong. The game was between P2 and the Cortes that represented 19 cities of Castile. The ordinary revenues had not increased as fast as the service of the *juros*. The fixed contribution of the cities had not been renegotiated since the early 60s, despite the growth of the economy (real and nominal). As the service on the *juros* neared the level of ordinary revenues, no more *juros* could be issued. After failing to increase some taxes, P2 stopped the payments on the *asientos*, short- to medium debt to the bankers. Since the *asientos* were financed by deposits to the bankers who were financial intermediaries, the credit market in Castile froze, commercial fairs stopped. The economic crisis eventually forced the cities to agree to a doubling of the *encabezamiento* and payments to the bankers were resumed shortly after.

3. *Were there any writing by John Law before he started his experiment that could provide an indication about his main ideas?*

Yes John Law had written in 1705 a treatise *Money and Trade Considered: with a Proposal for Supplying the Nation with Money* where he advocated for a national bank to augment credit/liquidity by issuing notes that would be backed by land. In his experiment in France, liquidity would be increased by notes that would be backed by the revenues of government and commercial ventures.

4. *Present the fundamental idea behind the system of John Law in about 10-15 lines. Go to the main point.*

The main point is mentioned in the previous answer. There were probably several ideas. First, the government debt (bonds) would be transformed into shares of a company that would own the government debt and profits from the trade charters that were granted by the government. In this sense, the government which had the right to grant these monopoly charters used them to reduce its debt burden (a little like the national domains in 1789). Second, the bank of JL (eventually Banque Royale) would issue notes to increase the liquidity and lower the interest rate (with a target of 2%). These notes would replace coins in the circulation of money. In this sense, the de facto merging of the bank and the company of the Mississippi, which today would be viewed as horrendous, like the Fed manipulating the stock market, was not so strange for JL who pursued his idea of monetizing real assets to increase liquidity, lower the interest rate and facilitate credit for trade.

5. *Present (or imagine) conditions under which his experiment could have worked.*

The shares of the company of the Mississippi were clearly overvalued. JL encouraged speculation, beginning with the scheme of the “daughters” and “grand daughters” that boosted the demand.

In addition, he required small down payments for the purchase of the shares and used his bank to facilitate through credit the purchases of the shares, something that would be unthinkable today. The absence of these tricks would have reduced the risk of failure.

6. *Compare the policy decisions in France about the default on the debt and Estates Generals in 1716 and 1788 (or 1789).*

In 1716, the composition of the EG in three orders, Church, nobility, third-estate, with equal representation for each would have generated a majority (Church-nobility) for a partial default of the debt because of the the distribution of wealth where land is owned more by the first two orders and financial assets (government debt) more by the third. Hence, the argument of Saint-Simon was that the regent could “pass the buck” to the ES. However the regent decided against calling the ES, probably because of other issues in domestic politics. In 1788, Louis XVI decided not to make the decision of default but to call the ES to make a decision. It is not clear that he did that because of the argument of Saint-Simon.

7. *What did the system of John Law and assignats have in common? What was the difference?*

In common, the backing of financial assets by real assets (taxes and company profit for JL, national domain for the assignats). In both cases, the financial instruments are transformed into money that replaces coins. In both cases, too much of these financial instruments are issued, leading to inflation. The differences: For JL, there was a process of deflation and redistribution of the ownership of the shares that were converted into perpetual government bonds (through the “Visa”). The introduction of paper money was a failure. For the assignats, after the Terror with its price controls, all controls were lifted, inflation took off and assignats were used to generate a very large amount of revenues through seignorage. After the end of the experiment in 1796, the currency was stabilized and paper money was adopted.

8. *The following figures describe events during the period of the assignats. (You are supposed to know the meaning of these figures).*

- (a) *Using the figures, comment on the quantity and prices of the assignats during the period of the Terror.*

The quantity increases (nearly doubles, see the crosses in the third figure), and the price is constant because of the price controls that can be enforced by capital punishment.

- (b) *Comment on the evolution of the nominal and the real values of assignats in the years 1795 and 1796. (You may use all three figures for this question).*

The quantity increases by a large amount (first figure). This is the regime of seignorage. The real value falls because of inflation (Figure 2). The inflation is seen in Figure 3 where the stars represent the real quantity of assignats (money) and the inflation rate at different points in time. These stars move along the schedule of the demand for money where inflation and the real quantity are inversely related.

- (c) *Comparing the two periods of the Terror and the one after (95 and 96), in which of these two period, do think that more revenues were generates by creating new assignats? Justify your answer. (Your argument is more important than your guess of the period).*

More revenues were created in the second regime. As seen in class, the amount of revenues through seignorage could be of the same magnitude as all the revenues before the revolution (about 40M livres per month).

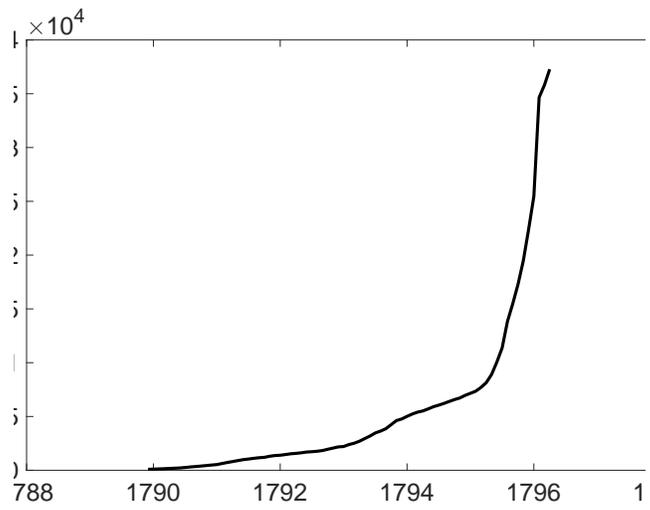


Fig 1: Nominal value of the assignats

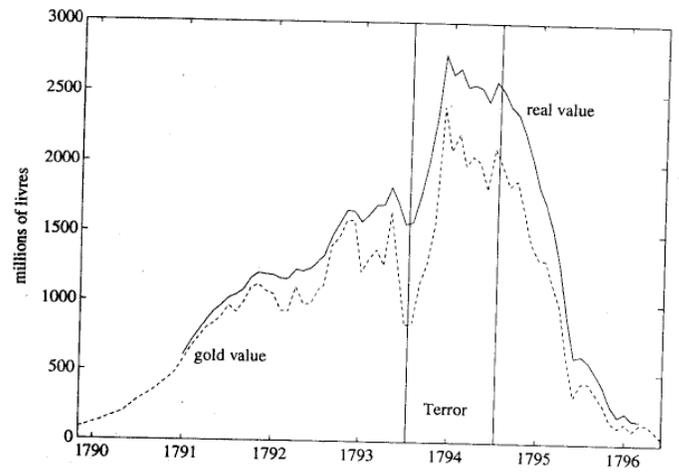


Fig 2: Real value of the assignats

