CHAPTER VI — CREDIT

I. HOW CREDIT IS SIMPLY AN EXTENSION OF EXCHANGE

Credit is only an enlargement of exchange — exchange in time instead of in space. It may be defined as *the exchange of present wealth for future wealth.*

For example: a wool spinner sells wool to a cloth manufacturer. But the latter has not the wherewithal to pay for it — he has no present wealth to give in exchange for the wealth that is delivered to him. But that makes no difference: the manufacturer gives in exchange the future wealth that he proposes to create out of this wool — that is to say, an equivalent value to be taken out of the value of the cloth when it is made.

Here the fact of exchange is perfectly clear: it is a real sale. The only way in which it differs from an ordinary sale is that it is a *credit* transaction and not a cash one. But this difference, which seems of little importance, has weighty consequences. It is no small thing to draw the future into the scope of our contracts.

Here is another form of credit in which the act of exchange is less easy to detect, although it is actually there. A farmer, having no wheat to sow, borrows some from his neighbour — that is to say, he engages to give it back after the next harvest. Of course he will not give back the same wheat, for he will have used that to sow his field, but he will give different wheat, drawn from his own harvest. The Roman lawyers well expressed it when they said that in cases of loan the thing was transferred in full ownership (they called it *mutuum*, because it made mine, *meum*, become thine, *tuum*) and that it was the same, conversely, with the similar thing given back when the time for payment arrived. If instead of wheat we imagine the loan to consist of a sum of money, which is the object usually borrowed nowadays, it is no less obvious that here there is still an exchange of present wealth for future wealth.[1]

[1] In the case of an object that the borrower has to return just as it is — such as a house or land, where the loan is called a lease — the definition we have given is no longer applicable. This is not exchange but *hire*, and it is no longer *credit*, in the proper sense of the term. I could hardly say that the landlord who lets me lodgings gives me credit, especially when he makes me pay the rent in advance, which is the rule for small lets!

Now these two operations — *sales on credit*, and *loans* — are the two essential forms of credit.

The essential characteristics of credit, therefore, are (1) the *consumption* of the article sold or lent; (2) the *expectation* of the new article that is to take its place. For whereas the man who lets a house or farm knows that it will be restored to him, and does not lose sight of it for an instant when it is in the hands of the borrower, the man who lends a thing for consumption knows that it is taken from him irrevocably. The sack of borrowed wheat will have to pass through the mill to become flour, or be buried in the furrow until the harvest. The sack of borrowed crowns, whatever use they are to be put to, will have to be emptied down to the last coin in expectation of the future money that the borrower hopes to make. Now that is a terrible position, for the borrower as well as for the lender, for this is what results:

(*a*) First consider the lender. He is exposed to considerable risk. No doubt he counts on receiving an equivalent amount of wealth to replace what he has lent, but this wealth is *not yet in existence*. It will have to be produced for this purpose, and whatever is future is by that very fact uncertain. Legislators have striven to guarantee the lender against all danger, and the precautions they have devised with this object constitute one of the most important branches of civil law: guarantee, liability, mortgages, etc.

When the debt is secured by the delivery of goods of at least equivalent value, movable or immovable (there need be no actual delivery of immovable goods, and sometimes not even of movable goods), then the maximum security is obtained and the credit is said to be *real*, meaning that the claim applies to a thing (*res*). Yet even in this case the security is not absolute, for the immovable goods mortgaged or the object given in pledge may lose their value. So a certain amount of confidence — an act of faith — is always required on the part of the lender, and that is exactly why the name "credit" is reserved for this particular kind of loan, for by its etymological origin it implies an act of faith (Lat. *credere*, to believe, or trust). And credit is more and more called upon to justify its fine name, because, as we shall see, *real* credit — that which is guaranteed by a pledge or mortgage — gives place more and more to *personal* credit, which, in the shape of current banking accounts or mutual credit societies, is founded entirely upon the word of the borrower. It will be said, no doubt, that this is a return to the past — to the days of ancient Rome, when the creditor had likewise no other security than the person of the debtor. But the difference between the two is great,

for then it was the very body of the debtor that served as a pledge — a body which could be imprisoned, whipped, and perhaps even cut into pieces (*partes secanto*, as the Law of the XII Tables had it) — whereas nowadays the only pledge of personal credit is the honour of the debtor, his moral and not his physical person.

(*b*) Secondly, consider the borrower. His obligation does not consist, like that of the tenant of a house or farm, simply in having to keep the thing lent and to maintain it in good order till he restores it at the appointed date. After he has made use of it — that is to say, destroyed it — he has to labour to build up an equivalent for it, with which to settle his debt on the day it falls due. *He must therefore take great care to employ this wealth in a productive manner.* If he is unwise enough to use it unproductively, for personal consumption, or if by ill chance he fails to produce an amount of wealth at least equivalent to that which he has borrowed, that means ruin. In fact, the history of all countries at all times is a veritable martyrology of borrowers ruined by credit.

Credit, then, is an infinitely more dangerous mode of production than those we have hitherto considered. It can only be of use in societies where economic education is highly developed.

II. CREDIT INSTRUMENTS

Credit really only comes into existence as a mode of production when the future wealth that is its real object is to some extent realized — although it does not exist — and enters into commerce in the form of *negotiable instruments*. The invention of these marked a real economic revolution, which may be assigned to the thirteenth century. It must be understood in the following way.

At the beginning, credit was not regarded as wealth, for it had no reference to a material object, nor to any wealth at all: it was a purely personal bond between creditor and debtor. In the significant words of the commentators, the obligation adhered to the body of the debtor — *ossibus haeret*. If the debtor failed to pay, the creditor could not seize his goods: there was nothing that he could seize except the very body of the debtor, and that is why, as we have just remarked, he could imprison it or even cut it into pieces. In these circumstances, the idea of *transferable* credit claims — the possibility of putting such a power into the hands of anyone else — could not possibly be entertained.

But the Roman lawyers soon took a great step forward, and credit claims came to be regarded as goods (*bona*). Then by means of

ingenious devices they were made transferable (by what was called *novatio* and *litis contestatio*). This transfer of credits, however, always remained more difficult than the transfer of material goods, and even to-day, according to the French Civil Code, the transfer of credit instruments involves somewhat complicated formalities — especially the notification to the debtor.

But commercial law, as has often been noticed, always advances more rapidly than civil law, and serves it as a pioneer. So, in the Middle Ages, it made an admirable double invention — that of representing a credit claim by a written document — a *bill of exchange* or a *promissory note.*

A bill of exchange is a document by which a creditor conveys to his debtor an *order to pay*, not to himself, the "drawer" of the bill, but to *a third person*, generally in another place or another country. For this reason bills of exchange have always been used mainly for settling transactions at a distance — between different towns or different countries.

If a merchant of Venice owed a merchant of Amsterdam a thousand ducats, instead of sending the ducats in coin (which was hardly a convenient proceeding in those days), he would hand them over to one of his brother merchants in Venice, who had a claim on Amsterdam. The latter would give him in exchange a letter ordering his correspondent in Amsterdam to pay a thousand ducats to whoever presented the letter to him. So the merchant of Venice would merely send his Dutch creditor the letter instead of the money, and thus settle his debt. It is the same nowadays. Originally, however, this letter or bill could only be used by the one who had drawn it. It was not till later on, in the fifteenth century, that the idea arose of making it negotiable by a mere note written on the back of it, called an *endorsement.*

The effect of the endorsement is not merely to make the settlement of transactions marvellously simple and to enable payment to be made without the use of money by the mere transfer of the bill. It also strengthens the value of the bill, because each of those into whose hands it passes, and who affixes his signature to the back of it, becomes severally responsible for the debt that it represents. The proverb that declares that "a rolling stone gathers no moss," is very much at fault here: the rolling bill is like a snowball, and grows big with added guarantees. It is therefore a perfect credit instrument.

Although the endorsement, however, gives additional ease of circulation to the bill, it also creates an obstacle, not so much by the

slight formality of having to affix a signature, as by the liability it involves. Let us go a step further: let us eliminate the endorsement itself, and create credit instruments that shall be transferable simply from hand to hand like pieces of money — bearer securities, cheques, and bank-notes.

That brings us to the last stage. Henceforth huge masses of wealth — not exactly fictitious wealth, but future wealth, which is quite different — are added to the mass of existing wealth, and circulate in the form of negotiable or "bearer" instruments. These documents are the object of an enormous trade that would in former days have appeared inconceivable, and the merchants who specialize in this trade are called bankers.

The creation of instruments representing capital is not only useful in facilitating sales, loans, and payments. It has a more curious and apparently an almost miraculous effect: it is equivalent to a *duplication of capital*, allowing two people to use it at once.

This is an enormous advantage, for if it is very advantageous for the purchaser, buying on credit, to keep his money at his own disposal for a certain time, it is, conversely, very disadvantageous for the seller to be compelled to go without it for the same period. A manufacturer has to make purchases and pay wages every day. He can only get along on condition of renewing his necessary capital from day to day by the sale of his goods. But if he sells them on credit — that is to say, without being paid for them — it looks as if it must become impossible for him to carry on.

What is to be done? It cannot be possible, it would seem, for the same capital to be at the disposal of two different persons, the lender and the borrower, *at the same time.* Yet such is actually the case; and it is the negotiable credit instrument that solves the apparently insoluble problem. In exchange for the capital that he gives up, the lender or the man who sells on credit receives a document — a piece of paper in the form of a promissory note, or bill of exchange, or what not — representing a value which can be sold, like all other values. If he wishes to resume his capital, nothing could be simpler: all that is needed is for him to sell, or *negotiate,* as it is called, this document.

Of course there is no magic about this proceeding, and the operation has a natural explanation, as we shall see in the next section.

III. WHETHER CREDIT CAN CREATE CAPITAL

Credit has acquired such importance in modern society that we are tempted to ascribe miraculous powers to it. Speaking constantly of great fortunes founded on credit, and recognizing that the most extensive enterprises of modern industry are built upon a basis of credit, we are invincibly persuaded that credit is an agent of production and that it can create wealth quite as well as land or labour.

But this is a complete illusion. Credit is not an *agent* of production: it is a particular *mode* of production (which is a very different thing), just like exchange, and just like division of labour. It consists, as we have seen, in the transfer of wealth or capital from one person to another; but to transfer is not to create. Credit can no more create wealth than exchange can create goods. As John Stuart Mill has admirably put it: "Credit being only permission to use the capital of another person, the means of production cannot be increased by it, but only transferred."

What serves to foster this illusion is the existence of credit instruments. We have seen that all capital that is lent is represented in the hands of the lender by a negotiable instrument of the same value. Hence it seems as though the act of lending has the miraculous effect of making *two* capitals out of one. The old capital of £1000 which has been transferred to the borrower, and the new capital represented by a note for £1000 in the hands of the lender — do not these two make £2000?

From the subjective point of view this paper note is, in fact, capital: it is capital for me, but not for the country as a whole. It is evident, indeed, that I can only negotiate it if someone is willing to give me in exchange for it the capital that he possesses either in money or goods. The document is not capital in itself therefore, but it merely gives me the *possibility of obtaining other capital in place of that which I have relinquished*. It is obvious, moreover, that whatever may be the use that I wish to make of the value represented by this piece of paper — whether I want to use it to pay my expenses, or for production — I can only do this by converting it into those objects of consumption or instruments of production that are already in existence on the market. It is by means of this real wealth that I shall carry on production or support life, and not by means of scraps of paper.[1]

[1] Léon Say, in his preface to Goschen's *Theory of the Foreign Exchanges*, says: "This absolute representation of property in the form of an instrument has dissipated

If every credit instrument — every debt — was actually wealth, then every Frenchman would simply have to lend his wealth to his neighbour, in order to double the wealth of the country at one stroke, raising it, say, from ten thousand millions to twenty thousand millions!

May we not at any rate say that these instruments represent *future wealth?* Certainly; but it is precisely because the wealth is future that we cannot count it. We shall be able to count it when it is born. Until then there will always be this marked difference between present and future wealth, that the first exists and the second does not! We cannot produce and we cannot live from wealth that is merely expected. We might just as well reckon, in taking a census of population, all those members of society who are to be born during the next twenty years.

But though credit cannot be called productive in the sense of creating capital, it yet renders important services to production by enabling us to *utilize existing capital to the best possible advantage.* In fact, if capital could not be transferred from one person to another, and if everyone were reduced to the necessity of employing what he possessed himself, an enormous amount of capital would remain unemployed. In all civilized societies there are many persons who cannot make use of their own capital. Among them are the following:

(*a*) Those who have *too much* capital. As soon as a man's fortune exceeds a certain sum, it is no easy matter for him to make use of it by his own ability alone, apart from the fact that in such cases he is scarcely disposed, as a rule, to take the necessary pains to employ it.

(*b*) Those who have *not enough.* Workmen, peasants, and servants, who have saved small sums of money, are unable to employ these small savings productively. Yet these small amounts may add up to millions when they are all put together.

(*c*) Those who are unable, owing to *age*, *sex*, or *occupation*, to employ their capital themselves in industrial undertakings. Such are children, women, and members of the liberal professions — lawyers, doctors, soldiers, clergymen, civil servants, and officials of every kind.

all the difficulties that used to hinder the maturing and transmission of rights. To-day, by means of a French bill on England, an English bill on Canada, a Dutch bill on the Indies, and *vice versa*, we can send factories and railways and, in fact, anything that can be owned. The thing itself remains motionless, but its image is conveyed unceasingly from place to place. It is like the play of mirrors sending reflections to the ends of the earth. The mirror is tilted, and the reflection strikes higher or lower, to the right, or to the left. The object itself is in one place, but it is made use of everywhere: whoever has the reflection, has the object."

On the other hand there is no lack of people in the world — captains of industry, inventors, agriculturists, and even workmen — who could make good use of capital if they had it; but unfortunately they have not got it.

If, therefore, capital can be transferred, by means of credit, from those who cannot or will not make use of it to those who are in a position to employ it productively, this transference will be of great benefit to both parties and to the country as a whole. In every country there are millions of pounds of capital that are thus withdrawn from sterile hoarding or from unproductive consumption, and made fruitful by means of credit. It has been well said that credit possesses the virtue of transforming *latent* capital into *active* capital. In short, credit plays the same part in relation to capital as exchange does in relation to wealth. We have already seen that exchange, by transferring wealth from one producer to another, does not create it, but enables it to be better utilized, and also promotes the better employment of natural resources and the labour of producers.

IV. HOW CREDIT ENABLES US TO DISPENSE WITH MONEY

That credit enables us to *postpone* payment is obvious enough, and follows from its definition; but it is not equally clear that it enables us to *abolish* payment; for sooner or later, it will be said, when the date of payment arrives, the debtor will surely have to pay up? But no; even that will not be necessary.

Suppose that every sale, instead of being paid for in money, is paid for by the creation of a credit instrument — a cheque or bill of exchange — and that these instruments are thrown upon the market and pass from hand to hand by successive transfers. The result will necessarily be that most of them end by meeting and cancelling each other, either by *compensation* or by *confusion*, as the lawyers put it.

Suppose that there are three countries, or three persons, whom we will call *A*, *B*, and *C*. Suppose that *A* is a debtor to *B*, and that *B* is a debtor for the same amount to *C*, who in his turn is a debtor to *A*. Is it not evident, then, that instead of passing the sum of money owed by these three debtors to their three creditors round the whole circle — making *A* pay £1000 to *B*, who then pays £1000 to *C*, who finally hands back the money to *A*, from whom it came in the first place — it is simpler to settle the whole business without paying a farthing?

But of course it will be said that it is highly improbable that C will be debtor to A in this convenient fashion, so as to close the circle, as it were. This is true; but if C is not a debtor to A, he will perhaps be a debtor to D, or E, or F, or G, or H, so that the credit instrument chances ultimately to reach someone who is A's debtor, and then the problem is solved. The more persons there are taking part in the game, the larger the circle will be, and obviously *the more chance there will be of closing the circle*, of buckling the strap, so to speak. Besides, there are intermediate agents whose express business it is to turn these chances into realities. These are the bankers, in whose hands the cheques and bills of exchange of A, B, C, etc., will eventually collect.

It was in international trade — in exchanges between one country and another — that merchants first had recourse to credit to enable them to dispense with money. The dangers and difficulties of transporting large sums of money over great distances inspired the Lombards, as we have said, with the idea of the *bill of exchange*, whose principal use was to avoid the conveyance of money from place to place and making many payments, one in each place. But if the transport of money was eliminated, payment was not. There was still one step to be taken to reach that end. Suppose that each of two places, say London and Paris, had drawn a bill of exchange on the other. Then each place was debtor and creditor for the same amount, and it is plain that these two debts could be extinguished by the method of payment called *compensation;* and if the amounts were unequal, compensation could take place none the less, up to the amount of the smaller of the two sums. All that would be necessary would be for the intermediate agents, the bankers, to undertake to balance the account.

But for these ingenious devices, in fact, international commerce would have been quite impossible. As we have already shown, the money that actually travels from one country to another represents only a very small fraction of the value of the goods exchanged.

But it is not only in international relations that credit instruments are able to take the place of money and make it unnecessary. It is the same among the inhabitants of a single town or a single country. In this case it is the cheque that is chiefly employed for the purpose (see below, p. 295).

Could not the cheque itself be replaced by simple booking operations? Suppose that all the inhabitants of a country open accounts in a single bank,[1] whose duty it is to receive all income for each of

[1] Or in the Post Office, where everybody is necessarily a customer. The postal cheque system was started first in Austria in 1883, and more recently in France.

its customers by entering it to their *credit*, and to make all their payments by entering them to their *debit*. At the end of the year the bank would send each customer his account, which would show a balance in favour either of the bank or the customer. This balance would be carried on to the next year, either to the debit of the customer (in the first case), or to his credit (in the second case), and so forth. It is evident that if this system were made universal, all transactions could in theory be settled by a mere process of book settlement — by what is called the *clearing system*. Then we should no longer see that army of collecting clerks, with bags attached to them by chains, who go about collecting cheques, and occasionally get murdered on the way!

By entirely doing away with the instrument of exchange,[1] however, such a system would tend, as Jevons observed, to take us back to barter — to the direct exchange of goods for goods. This phenomenon is similar to that which tends to eliminate the merchant and bring producer and consumer into touch with each other by means of co-operative societies.[2] In fact there is a curious resemblance between the ingenious and complicated proceedings that constitute the last word in economic progress, and the primitive operations of societies still in a state of barbarism. Nor is it the first time that we have noticed in the historical development of races that peculiar mode of advance of the human mind, which seems to return almost to its starting-point when it has reached the end of its progress, describing not exactly one of those great circles that so vividly impressed the imagination of Vico, but rather a curve that rises in an upward spiral.

We saw in the last chapter that international trade tends automatically to take the form of barter, the tendency being always for exports to balance imports. And do we not also arrive at a kind of

[1] The abolition of money as an instrument of exchange would not necessarily involve its abolition as a standard or measure of value. But gold money would no doubt serve this purpose only potentially, remaining shut up in the vaults of the banks, like the Imperial Standard Yard, which is immured at the Houses of Parliament.

[2] Many other equally curious instances of this can be found in the other social sciences. Thus there is a tendency for the verbal formalism of primitive legislation to reappear in modern legislation, in the shape of formulas entered in registers and creating rights; direct government by the citizens of ancient cities reappears in the *referendum* of modern constitutions; compulsory military service for all citizens takes us back to the system that preceded the formation of standing armies; and so forth — not to mention the many curious revivals of ancient warfare in the weapons, helmets, war chariots, etc., of the late war.

barter on the hypothesis that we have just worked out — the supposition that all the inhabitants of a country are customers of a single bank? Such a social system, in which there would be no need of money, could only take effect because everyone would pay for the products or services he consumed with his own products or his own services.

It is also a kind of barter that is practised in that wonderful institution called the *Clearing House* (see below, p. 297), for those huge bundles of cheques and bills that are exchanged and set off against each other every day are merely symbols that stand for the piles of boxes, bales, and barrels actually exchanged. To anyone who can look behind the scenes, the Clearing House appears as a great market, like those of the African tribes or of the vanished cities of the past, with this one difference, that instead of an actual exchange of goods we have an exchange of the credit instruments that stand for them.

Money thus tends to become a pure abstraction. Yet how far we are from the crude system of barter, despite this superficial resemblance! For money, and the wealth it stands for, appears everywhere in its different forms — metal, paper, and instrument of credit — though dematerialized and, as it were, sublimated.