

CHAPTER IV — PAPER MONEY

I. WHETHER METALLIC MONEY CAN BE REPLACED BY PAPER MONEY

No one knows who invented paper money. It was known in China from times immemorial, and Marco Polo, the fourteenth century traveller, brought back an account of it. And among the many kinds of money used in ancient times, if we find no record of paper money we at least hear of leather money, of purely conventional value. This was called *obsidional* money, or siege money, because it was generally issued in besieged towns, as a substitute for the metallic money that was wanting.

If we did not already know from daily experience that paper money can be substituted for metallic money, we should find it hard to believe, and the question at the head of this section would seem absurd. In the case of bank-notes there is no mystery about the matter. The bank-note is only a symbol standing for an equal value of gold or securities lying at the bank, and though most people in whose hands they circulate are ignorant or careless of the fact, it is easily comprehensible that they are accepted as money. But in the case of *inconvertible* paper money — pieces of paper issued by the State with no promise of repayment (at least not at any fixed date), and with no backing of gold or silver or securities — some surprise is quite justifiable.

We certainly could not replace wheat or coal or any other kind of wealth by mere slips of paper bearing the words "One Hundred Bushels of Wheat," or "One Hundred Tons of Coal." Such scraps of paper could never feed us or warm us. And even if we used coins merely to hang round our necks, as girls do in the East with their gold and silver sequins, it is plain that many-coloured pieces of paper could not take their place.

But we know that money is unlike other forms of wealth, and that its utility in our civilized societies is of a quite immaterial kind. A piece of money is nothing but an "order" that gives us the right to claim, under certain conditions, a portion of the existing stock of wealth (see p. 212). Now a slip of paper can play the part of an "order" just as well as a piece of metal, and even much better, so

far as ease of circulation is concerned. The honour of having perfectly understood and demonstrated this possibility is due to the financier Law, although his premature experiments led France into bankruptcy. But the best proof lies in the fact that the use of paper money is becoming more and more general. Why should it not, indeed? If these scraps of white or coloured paper can be invested by law and general agreement with the property of enabling us to pay for our purchases, our debts, and our taxes, why should they not circulate just as well as white or yellow coins? For these coins are only used for the same purpose.

It may even be observed that the prospect or the certainty of repayment at a longer or shorter date has scarcely any weight with the general public, however much it may have for the financier; for what difference does it make to a man who receives paper money to know that he will be able to exchange it, at some unknown date, for gold or silver? No one intends to keep it until that time arrives. It is enough to know that if you accept it you can pass it on to someone else who will accept it likewise. Its circulation is a reciprocal act of faith.

It is a remarkable fact with what facility the most economically backward populations accept the substitution of purely conventional money for money that is genuine merchandise. It is to be presumed that many of the primitive forms of money, such as cowrie shells, were conventional ones, for they hardly had any value as food, and still less, among the tribes that employed them, as objects to be hoarded. At any rate, experience has constantly shown — even recently among the native tribes of Morocco — the eagerness with which paper is accepted, after some hesitation, in place of the heavy silver coins with which men have always been familiar. And the history of all wars, especially the late great war, furnishes many proofs of this interesting psychological fact — interesting because it shows the part played by faith in human affairs, and even in men's notions of wealth. In most French towns the people themselves demanded the issue of paper money to remedy the shortage of small (metallic) change. The dirtiest of paper notes were accepted everywhere as eagerly as gold napoleons, and the fine gold money was carried with the greatest readiness imaginable to the Bank of France to be exchanged for notes. More than two thousand million francs (£80,000,000) were thus brought voluntarily. Not only did paper money circulate without any difficulty, but people started to hoard it in place of gold, which is the highest honour that could be accorded to it!

Again, the circulation of a conventional sort of money is less surprising if we consider that the value of metallic money itself is to a large extent conventional, for when we are told (as the text-books often tell us) that all good gold or silver money has an intrinsic value equal to its nominal value, we must not be led astray by that word *intrinsic*. If the little lump of gold that is made into a sovereign has really a commercial value of one pound, it is largely because it is useful for making into a sovereign or any other gold coin. If it served only for making jewellery or gilding picture-frames it would certainly not be worth a pound: it might not even be worth five shillings.

The other idea, however, is an illusion that is cherished by many economists — or, at any rate, one against which they do not sufficiently warn their readers. Most of them seem to assert that the impression stamped by the State on the pieces of gold and silver simply declares their real value, like the labels that tradesmen attach to their goods. But the declaration that the piece of gold weighing 123.27447 grains is worth a pound is not merely *declaratory* of value: it is partly *attributive* of value. It is because the will of the legislator — ratifying, if you like, the free choice of mankind — has raised gold and silver to the supreme dignity of becoming money, that these metals have acquired the chief part of their value. But if ever gold or silver money were to be demonetized, its possessor would find only a very much depreciated security in his hands.

There is nothing in this that is peculiar to money. Human choice always plays a certain part in conferring exchange value upon any object whatever, but if this choice is determined by *natural* causes, the resulting value will be partly natural and partly conventional. Wheat itself is only valuable because the majority of civilized men have adopted it, among other cereals, for food, and no doubt if custom were to substitute for it some other kind of food, its value would disappear. Yet no one would think of calling the value of wheat “conventional.” It is the same with the precious metals. There was nothing arbitrary about human choice when it was directed upon these metals: it was dictated by the very real qualities they possess — qualities that we have already enumerated. The sole difference is that it is easier to replace the precious metals as money than to find a substitute for wheat as food.

It must be acknowledged, however, that there will always be important differences between the value of metallic money and that of paper money. They are as follows:

- (1) As paper money has only the value that the law confers

upon it, it cannot pass beyond the boundaries of the region that is subject to that law. It cannot be employed, therefore, in settling international exchange operations. The value of metallic money, on the contrary, is practically the same in every civilized country, since it depends on the value of the metal itself. It can therefore circulate everywhere, as bullion if not as coin. That is why metallic money is essentially the *international money*, whereas paper money is essentially a *national one*.¹

(2) Paper money has no commercial value, as it rests entirely on the will of the legislator, and the law that created it can likewise abolish it. If paper money is demonetized by law, nothing is left in the hands of its owner but a worthless scrap of paper: when its legal value is lost, all is lost. It is not altogether the same with metallic money. Besides its legal value, this has also a natural value — much less, to be sure, than its nominal value, as we have just said, but none the less a *commercial value* that it owes to the physical properties of the metal of which it is made; and these are far from being common and unimportant. Consequently, even if metallic money is demonetized by law, the owner of the coins does not lose everything. No doubt if gold and silver were demonetized *by all countries*, metallic money would lose the greater part of its value, because its chief market, the various national mints, would be closed to it. This is proved by the fact that silver has suffered a considerable fall in value merely through the demonetization of silver money by several countries. All the same, even on this extreme supposition, the precious metals would still preserve a certain amount of utility, since they could be employed for industrial purposes; and as these industrial uses would become more important and more numerous the greater the fall in the value of the metal, the fall might not be as great as is imagined. Suppose the metal were to lose two-thirds or three-quarters of its value. A certain value would still remain in the hands of the owner of the coins — a value of which the law could not deprive him, and which would probably be greater than that of any other commodity that could be chosen as legal money, after it had been demonetized.

(3) Finally, the value of paper money is generally more variable than that of metallic money. This is because its quantity

¹ Yet a Bank of England note, it will be said, is generally accepted abroad. — This is so; but in this case it is accepted not as money but as a credit instrument — that is to say, with the intention of sending it back to England *to be cashed*. The traveller discharges his debt to his landlord with it, but his country's liability is not liquidated, for the note will have to be paid for eventually in goods or securities.

depends on the will of men, while the quantity of metallic money depends only on natural causes, such as the discovery of new mines. One is issued by governments, and the other by nature. It is therefore in the power of a thriftless legislator to depreciate paper money by issuing it in excessive quantities — an occurrence which is only too common, — whereas it is not in the power of any government to *depreciate metallic money by an excessive coinage of it.*

It is true that the discovery of exceptionally rich mines may flood the world suddenly with a considerable quantity of the precious metals, and consequently lower the value of metallic money. But these variations in the quantity of gold and silver never cause the same rude disturbances as variations in the quantity of paper money, because they extend over the whole area of the civilized world. The precious metals are everywhere sought after and accepted, so if they are overabundant in one country, they quickly flow of their own accord into others, whereas sudden increases in the supply of paper money may become disastrous, since such money is always restricted to one country, which forms, as it were, a closed reservoir, beyond which it cannot flow.

Such, then, are the disadvantages which make paper money a more dangerous instrument to handle than metallic money. They are far, however, from justifying the curses denounced against it, as when it is said that "it is the greatest scourge of nations: it is in the moral sphere what plague is in the physical."¹ At this rate all Europe is plague-stricken to-day. It must even be observed that these dangers might be mitigated and almost completely eliminated if we could imagine an international agreement concluded between all civilized nations, by which they all agreed:

- (1) To give legal currency to the same paper money;
- (2) Not to increase its quantity, or to increase it only to an extent fixed upon beforehand — for instance, in proportion to the increase in the population of each country.

In this case the value of the paper money, though always conventional — artificial, if you like — would none the less be as broad-based and more stable than that of metallic money itself, simply because it would be founded on the unanimous consent of the peoples of the various countries. For though it is true, as we have said, that one is issued by nature and the other by governments, it must be remembered that nature is always blind, whereas there is always a possibility that a syndicate of States might be enlightened! To-

¹ These words, often attributed to Napoleon, are really those of one of his ministers, M. de Montalivet (Circular of the 10th October, 1810).

day, as we shall see, there are sufficient means of information available to enable the issue of paper money to be regulated according to the need for currency. Then, as its quantity would be determined by scientific forecasts and not by mere chance, its value should be less subject to variation. The money of the future will probably be of this kind.

Besides, the fact that paper money is artificial is by no means a mark of inferiority, but quite the reverse. The chronometer is an artificial instrument for measuring time, whereas the sun is a natural one. But that does not prevent the former from being far superior to the latter for this purpose. It is even a characteristic of progress to substitute artificial instruments for natural ones: to replace the club by the rifle, the horse by the locomotive, the sunlight by the electric lamp, and the heat of the sun by artificial heat.

II. WHETHER THE CREATION OF PAPER MONEY IS EQUIVALENT TO THE CREATION OF WEALTH

The men who first conceived the idea of making paper money flattered themselves that they were thereby increasing the general wealth, just as if they had discovered a gold mine or found the philosopher's stone dreamed of by the alchemists, which would transmute other metals into gold.

In this shape the notion was evidently absurd, for it assumed that wealth could be created out of nothing. Yet the idea has been ridiculed too much, for it is perfectly true that the issue of paper money can to some extent increase the wealth of a nation. How can it do this? Adam Smith was the first to explain it. He showed that the metallic money circulating in a country is unproductive capital, and that the substitution of paper money, by making this capital available, enables it to be utilized and applied to productive purposes. Using a simile that has become very famous, he said that it was just as if means had been found of travelling in the air, whereby the whole surface of the earth that was taken up by roads could be restored to cultivation and production.¹

Adam Smith's ingenious comparison, however, leaves some obscurity in our minds. We can see readily enough that when roads

¹ ["The gold and silver money which circulates in any country may very properly be compared to a highway The judicious operations of banking, by providing, if I may be allowed so violent a metaphor, a sort of waggon-way through the air, enable the country to convert, as it were, a great part of its highways into good pastures and cornfields, and thereby to increase very considerably the annual produce of its land and labour." (*Wealth of Nations*, Book II, Chapter II.)]

and railways are no longer required, the land they occupy may be cleared and given up to cultivation and production. (This would mean something like a million acres in France alone.) But it is not so easy to see what can be done with metallic money when means have been found of dispensing with it. Is it to be melted down and made into gold and silver plate and ear-rings? The gain in that case would be very slight. No; it would be used in making purchases or investments abroad, either in buying railway shares or other securities, land, or ships, or in renewing industrial or agricultural plant — investments which, in one way or another, would increase the income of the country. Money employed at home can furnish an income to individuals, but not to the nation.

This is the same thing as is done by families that possess plate or jewels of considerable value, when they replace them by imitation metal or imitation stones and invest the capital obtained by realizing the genuine articles, so as to increase their income. Or it is like the action of those prudent individuals who, knowing that money brings in nothing so long as it lies in their pocket or their cash-box, are careful to keep by them only just as much as is necessary, and invest all the rest. The richest folk are often those who have least money by them. The thrifty peasant has some secret drawer full of gold and silver coins, but the millionaire has nothing but a cheque-book with which to pay his tradesmen. Nations can do the same. While France was employing some three or four hundred million pounds-worth of metallic money, England, more experienced in the use of credit devices, was content with a hundred and twenty million. Yet England was certainly no poorer than France on that account, but quite the reverse.

When, therefore, the question is asked, "Is it in the power of a government, or even of the banks, really to increase the wealth of a country by issuing paper money?" the answer must not be an absolute negative. As a matter of fact the thing is feasible, but *only up to the total amount of the metallic money in existence*. If England's £120,000,000 of cash were replaced by an equal amount of notes, England's wealth would be increased by £120,000,000 — but not by a farthing more.

It must be observed, however, that though the gain just mentioned might be realized by some countries, it could not be realized *by all countries at once*. One country may utilize its stock of metal productively by selling it abroad, but if every country wished to do the same it is obvious that none of them would succeed. In that case the gold or silver coins offered by all countries seeking to get rid of

them, would retain only their industrial value, and even that would be very much depreciated owing to the increase in the supply. It would be different if means were found of doing without roads: then *all countries at once* might benefit equally from the new utility of the land that used to be employed for transport and that had become available for cultivation. In this respect Adam Smith's picturesque simile fails somewhat, in our opinion.

Yet it remains true in the sense that even supposing metallic money to be replaced everywhere by paper money, the human race would henceforth save all the labour that it is obliged to employ in maintaining its stock of metal — in filling up the gaps made every day by wear and tear and accidental loss, and especially in keeping the supply at the level required by the needs of commerce and an ever-growing population. This labour is no small matter. The extraction of gold and silver from the mines, and its smelting, transport, and coinage, demand the labour of hundreds of thousands of workmen. Do away with the necessity for employing the precious metals, and all this labour will become available for new production, and the productive power of humanity will be to that extent increased.

Summing up, then, we see that the answer to the question at the head of this section is very different from that which used to be given. We must no longer say that paper money increases the wealth of a country *to the extent that it increases its stock of money*, but, on the contrary, *to the extent that it enables it to be diminished*.

III. THE EXCESSIVE ISSUE OF PAPER MONEY AND THE SIGNS BY WHICH IT IS INDICATED

We have estimated the *economic* advantages that may result to a country from the issue of paper money. But they concern only the economist, and they are never the motive that decides a government to issue it. The end that governments have in view is a simpler and more practical one — it is the *financial* advantage that accrues. When a government finds itself short of money, the creation of paper money is a very convenient method of paying its contractors and officials and meeting all its expenses, *without having to borrow, and consequently without having to pay interest*. When a government is in this situation it may be imagined that its credit is not very good, and that if it needs money, either it will find no lenders, or else the rate of interest will be very high. That is why so many States have had recourse to the issue of paper money, and on the whole there has been no particular harm in it when they have had the sense not to

exceed the amount required by the needs of the country — an amount which is represented by the quantity of metallic money in circulation. But unfortunately there is a great temptation for an embarrassed government to overstep the fatal limit. Many have yielded to it, and some, but not all, have ended in bankruptcy.

The grievous history of the French *assignats*¹ is well known. They were secured on the confiscated property of the *émigrés* and the church, but they were issued in quantities enormously greater than the value of that property, up to the extravagant figure of forty thousand million francs — probably twenty times the amount of the metallic money in existence at that period. Even if the issue had consisted of good gold and silver coins it would have resulted in considerable depreciation, since it would have been twenty times as much as was needed. So it can be imagined what must have been the depreciation of mere paper money. A pair of boots cost 4,700 francs, a ream of paper 450 francs, and the subscription to the *Journal Officiel* 1,000 francs.²

However, in the existing state of economic knowledge, a government that exceeds the limit is altogether without excuse. There are certain signs, familiar to the economist and the financier, that reveal the danger even at a distance, and give surer indications of it than those the pilot draws from the beacon and the sounding-lead.

(1) The first of these signs is the *premium on gold*. As soon as paper money has been issued in quantities too great for the needs of a community, it begins to be depreciated, in accordance with the universal law of value; and the first effect of this depreciation — the first sign that reveals it, even though the general public may not be aware of it — is that metallic money commands a premium. This means that its value stands out above the level of the depreciating monetary instrument, as rocks emerge above the retreating tide. Bankers and money-changers begin to seek for it to send

¹ [The paper currency of the French Revolutionists, issued in 1789, abolished in 1797.]

² These fantastic prices are far exceeded in Russia at the present time: bread, 250 roubles a pound; sugar, 900 roubles a pound; butter, 1,500 roubles a pound; boots, 30,000 to 50,000 roubles a pair; a suit of clothes, 50,000 to 100,000 roubles, and so forth. And the rouble, at par, was worth 2.66 francs, or about 2s. 1½d. The cause here is the same as in the case of the *assignats*. Even in Germany the issue of notes had reached 13,000 milliards of marks by the middle of 1923. These fantastic figures, however, represent only a small and continually diminishing value in gold, for in cases of inflation a critical point is always reached at which the depreciation of the notes proceeds faster than the increase in their number. From that point onwards, the more notes that are issued the greater is the *shortage of money*.

abroad in the form of bullion, and they pay a small premium to obtain it. That is the time for financiers to keep their eyes open!

(2) The second sign is the *flight of metallic money*. However slight the depreciation of paper money may be, if it is not immediately remedied by the withdrawal of the surplus paper but is allowed to continue and increase, then the little metallic money still remaining will disappear. This phenomenon is very characteristic: it has shown itself in every country where the paper money system has been abused. It has taken place for a long time in every country of South America, notwithstanding that these are gold and silver mining countries, and it is the same to-day in the countries that were lately at war. We explained the phenomenon in detail in connexion with Gresham's Law, so we need not do so again (see pp. 222).

(3) The third sign is a *rise in the rate of exchange*. We have not yet spoken of the foreign exchanges, but it is easy to understand that claims on foreign countries — bills of exchange or cheques — are the subject of extensive dealing in all the commercial centres of the world. They have a market price like other commodities, and this is called the *rate of exchange*. These claims on foreign countries are always payable in gold, since gold is the international money. A bill of exchange on London is therefore regarded in foreign countries as equivalent to gold, and consequently, when gold is at a premium the bill of exchange benefits by the same rise in price.

(4) The fourth sign is a *rise in prices*. This only appears at a later stage, and shows that the evil has already become serious and that the permissible limit has been greatly exceeded. It must not be thought that the merchant raises his prices as soon as the paper money begins to depreciate. He ignores it, just as the public does, and they only begin to realize that depreciation has taken place when it is revealed by the rise of prices. What really starts the rise is the abundance of paper notes, which pour into everybody's hands and enable everyone to increase his demand for goods. The evil, which had been latent until then, bursts forth and is revealed to all.

It must be observed, however, that the old prices remain unchanged for those who can pay in metallic money, if, indeed, there is any of it left. Hence we get the curious spectacle of a *duplication of prices*: each commodity henceforth has two prices, one payable in metallic money and the other in paper, and the difference between them is the exact measure of the depreciation of the latter. But the phenomenon, though a strange one, is only temporary, for the gold, disappearing from circulation as soon as ever the depreciated paper money appears, can no longer be used in making purchases.

As soon, therefore, as a government notices these premonitory signs — the flight of gold, the premium paid for it, and the rise in the rate of exchange, — its first duty is absolutely to forbid the issue of any more paper money: the limit has already been reached. If it has had the misfortune to overstep this limit, and sees the appearance of those dangerous symptoms, a rise in prices and a duplication of prices, it must reverse its engines and destroy all the paper money that returns to the public treasury, until it has got back to the right amount. But it is not always possible to apply this heroic remedy. In fact, to stop the issue of paper money, a government would have to be able to resort to other means of procuring money — by borrowing, for instance; and to be able to make up for the excess of paper it would have to have a surplus of revenue over expenditure. It is because these conditions could not be fulfilled during the war, in most of the belligerent States, that the issue of paper money continued, notwithstanding the rise in prices and in the rate of exchange.

Although these premonitory signs that we have just described are of great value to governments, they are also extremely disagreeable, for the simple reason that they give information to the public as well, and involve the risk of causing disquiet. Consequently, governments strive to prevent their appearance. That is why an emergency law has been made in France since the war, forbidding, on pain of heavy penalties, the export of metallic money at a premium — what is called *agio* — and even all dealings of the same kind.¹ It is illegal, therefore, to offer or receive more than a hundred francs in bank-notes for a hundred francs in gold. Such transactions being forbidden, there is no premium on gold — at least no apparent one, — and no duplication of prices. It is true that the law cannot prevent a rise in the rate of exchange or in prices, but the general public does not worry about the rate of exchange, or is even ignorant of the rise, while as for the rise in prices, it attributes this to any other cause than the depreciation of paper money.

¹ Law of the 12th February, 1916. It has been put into force on many occasions, but has not succeeded in preventing either the secret business of melting down metallic money or its illegal export.

Perhaps it would have been wiser not to attempt to interfere with the free play of economic factors, such as we have just indicated, and to allow a premium on gold and the duplication of prices. The gold price would then have remained the true price, and it would have made it easier to return to it some day.