

## CHAPTER VII — BANKS

### I. FUNCTIONS AND HISTORY OF BANKS

We have seen that the exchange of commodities is almost impossible without the aid of certain intermediaries, called merchants or traders. In the same way, trade in capital would be impossible without the assistance of intermediaries called *bankers*.

The history of banking is closely connected with the history of trade since the Middle Ages, and each great bank that has been established marks a new stage in commercial development. The first banks were those of the rich Italian republics, Venice (?1400) and Genoa (1407). Commercial pre-eminence passed thence to Holland, and we see the appearance of the famous Bank of Amsterdam (1609), soon followed by those of Hamburg and Rotterdam. Finally the establishment of the Bank of England, in 1694, shows how England was about to succeed to the commercial supremacy of the world. The Bank of France came much later — not till the beginning of the nineteenth century. But in 1716 Law had founded a remarkable bank that was in advance of the time, but was famous mainly for its sorry end.

Bankers were originally merely dealers in money — *money-changers*, as they would be called to-day. In London, in the seventeenth century, the goldsmiths played this part. But while money-changers nowadays do a very insignificant business, being found only in frontier towns or at railway stations, where foreigners need to change their money, in the Middle Ages it was a very different matter. The enormous variety of moneys (for each feudal lord had the right to coin money), and the frequency of secret debasement or counterfeiting, often committed by the sovereign himself, gave great importance to these banks, where anyone could obtain good money on payment of a premium.

Bankers are traders, just like other traders. While others deal in merchandise, bankers deal in circulating capital represented by credit instruments or cash. Other merchants buy in order to sell again, and make their profit by buying as cheap as possible and selling as dear as possible. Bankers borrow in order to lend again, and make their profit by borrowing as cheaply as possible and lend-

ing at the highest rate possible. But it is easy to understand that these traders exercise an economic function of the highest importance, for no goods are as important as money, at least in modern times, and those who hold the money have the power to dispense fortune or ruin — according as they grant money or withhold it — or at least to render the merchant and manufacturer powerless. In business, the suppression of credit means death.

Such, then, are the two fundamental operations of banking: borrowing and lending. And since borrowing is generally performed by means of *deposits* and lending by the method of *discount*, banks are frequently described as “banks of deposit and discount.”

But besides these two fundamental operations, banks perform many others. Thus there is the loan made simply on the honour of the borrower, which consists in his opening a credit, generally in the form of a *current account*. The account is a debtor when the customer draws more than he pays in, and a creditor when he pays in more than he draws. At the same time, this method of “open” lending, as it is called, is very dangerous, and offers no real security. As it requires a very accurate estimate on the part of the bank manager of what each of his customers *is worth*, some banks refuse to undertake it. It is absolutely forbidden by the regulations of the Bank of France.

Secondly, there is the method of *advancing money on securities*, which is a loan made in return for the pledging of transferable securities deposited by the borrower. These securities ought always to represent a sum greater than the amount of the loan, so as to cover the risk of depreciation.

Thirdly, there is the method of *carrying over*, which is also a loan on securities, but a short-dated one. It is for the benefit of those who have bought securities on the Stock Exchange, are not in a position to pay for them on the appointed day, and wish therefore to “carry over” the payment for their purchase till the following month.

Fourthly, there is the financing of *industrial companies* — a sharing in the creation of businesses, either by advancing capital or by subscribing shares — a speculative operation not generally undertaken by the great French banks, but one that is practised on a large scale by the German banks and has contributed not a little to the industrial progress of their country.

And, fifthly, there is the method of *mortgage*. This is a special operation that is incompatible with those just enumerated, and that should be reserved for special establishments. (See my *Political Economy* for mortgage loan societies.)

Finally, banks are not limited to borrowing in order to lend again. They also perform various services for their customers, whether these be traders, States, or private individuals.

To capitalists they render the service of *keeping their securities* and receiving the dividends, which is a great convenience for them, and they also facilitate the employment of their savings by recommending good investments. This is a source of considerable profit to the banker, not because of the very slight charge he makes, but because in this way he becomes the steward of his customers' wealth. He controls the sale of their securities and the reinvestment of the proceeds.

Another service that banks render to their customers is that of facilitating their payments to their tradesmen and other creditors by providing them with books of cheques payable out of their account, and with *letters of credit* on foreign banks, when they travel abroad.

To States and great companies they render the service of bringing their loans to the notice of their customers. As they do not do this for nothing (far from it!), and as these operations sometimes run into millions, this is a most profitable business for the banks.

It is not necessary that one bank should carry on all the business just described. The law of specialization and division of labour applies in banking as in other branches of commerce. Some of these operations, it may even be said, are incompatible with the others. Thus banks of deposit cannot undertake the financing of industrial companies, or even the discounting of long-dated bills, such as those drawn by an exporter on his customers in distant countries, or any kind of lending that involves a more or less permanent immobilization of capital, not to mention loans on land; for such banks must always keep their funds available for repayment on demand. So special banks are required for assisting in the creation of business undertakings and for developing the export trade.

The law of concentration, as it is called, makes its action felt in banking no less than in other forms of commerce. It is natural that the same movement that has led to the establishment of large shops should lead also to that of large banks. This is very apparent in France, where during the last thirty years several banking establishments in the form of joint-stock companies — notably the three whose names are so well known: the *Crédit Lyonnais*, the *Société Générale*, and the *Comptoir d'Escompte* — have extended their branches over the whole country and subjected the local banks, which are generally private undertakings, to overwhelming compe-

tion. The same movement has taken place on a far larger scale in other countries.<sup>1</sup>

The local banks, however, do not completely disappear, because they are better able than the larger credit establishments to assist and develop local industries. If their funds are insufficient for this, they can combine and form federations. Such a tendency was apparent before the war, and will no doubt be accentuated now.

## II. DEPOSITS

The banker's first task is to procure capital. How is this to be done? He can, of course, to begin with, use his own capital, if he has enough of it, and that is what most provincial bankers do. If the bank is constituted as a joint-stock company, then its capital is made up of the shares subscribed by all the shareholders, and may amount to millions of pounds. The bank can use this capital for its operations, and some great banks do this, but it is the exception rather than the rule. Great banks, at least discount banks, do not generally employ their own capital, whether privately owned or subscribed by shareholders, for the purposes of their banking operations. It appears only as a guarantee fund.<sup>2</sup> Why is this? Because this capital is too expensive. It would have to be entered in the books at the current rate of interest, 5% or 6%, and consequently the bank could not lend it, except at a higher rate, without loss. The banker must therefore conduct his business with the *money of the public*, and he borrows it for that purpose. There is a cutting saying in a comedy which declares that "business means dealing in other people's money"; but in banking at any rate this is the bare economic truth: it is the very essence of the banker's trade.

Moreover, the interests of trade require that it should be so; and not only the interests of the banker, for, as we have just said, if the banker employed only his own capital or that of his shareholders, he could not discount bills at so low a rate as 3%, as is often done.

But how will the banker borrow this money? He will not borrow as States or towns or industrial companies do — borrowing capital that the owners wish to invest for a long period, in the form of bonds

<sup>1</sup> [Compare the corresponding movement in England, by which most of the local banks have been gradually absorbed by the five great banking companies.]

<sup>2</sup> Most great banks invest their own capital either in real estate or in securities, as a reserve or guarantee fund for their customers. Such is the case, for instance, with the Bank of France.



or shares. This method requires a higher rate of interest than the banker can afford if he is to make a profit. What he asks the public for is the circulating or floating capital that everyone has in his pocket or his cash-box. In every country there is a large amount of capital in this form — capital that is not yet fixed, which does nothing and produces nothing, but merely waits for employment. The banker says to the public: "Entrust that capital to me until you have found a use for it. I will save you the trouble of taking care of it, and will give it back to you when you need it, on demand. That in itself is a service I will perform for you. But, besides that, I will pay you a little interest on it — say 1% or 2%.<sup>1</sup> That is at any rate more than the money will produce for you, for in your possession it brings in nothing at all. Finally, I will render you yet a third service, for I will be your treasurer, and pay your tradespeople in accordance with your instructions, which will be a great convenience to you." That is what is called a *deposit*.<sup>2</sup>

When these offers are heard and understood by the public, bankers can thus obtain a large amount of capital on very easy terms. Deposits are therefore the source of a bank's life: it is by them that banks are fed, and by them that they, in their turn, feed industry with circulating capital.

Still, if it were necessary to wait for the public to bring along its available money, as is done, for instance, in savings banks, the amount of the deposits would remain somewhat limited. Deposits must become automatic if the source or spring we have spoken of is to flow abundantly. How, then, are they to become automatic? They can only become so when capitalists, even the smallest of them, make a habit of depositing all their wealth with the banks and entrusting them with the duty of drawing the income from it. Then their account grows by itself, every time dividends are payable, by the amount of the coupons attached to the securities. In countries

<sup>1</sup> It may even pay no interest. Some banks, such as the Bank of England and the Bank of France, pay no interest on deposits, considering that the safe keeping of the money is a sufficient service to depositors. And the fact that they none the less receive enormous sums on deposit proves that they are right. Furthermore, it was formerly the rule for those old deposit banks already mentioned to charge depositors for the keeping of their money, because in those days the banks did not invest the money deposited with them, and made no profit out of it.

<sup>2</sup> The word *deposit* must not be taken here in the legal sense. Strictly speaking, a deposit is something sacred which the depositor must never withdraw, whereas a deposit of money in the bank is a kind of loan that the banker has every intention of utilizing and that he accepts only for that purpose. It is different in the case of a deposit of *securities*, which the owner leaves with his banker for him to take care of and to draw the income. In this case the banker cannot dispose of them.

like England and America where this habit exists, all idle money is drained from circulation and pumped in by the banks where it can be usefully employed.

But there are some countries, on the other hand, where having a banker is a luxury reserved for millionaires. Such was the case till recently in France, and it is so to some extent even to-day. The small capitalist likes to keep his securities himself; he only feels that he owns them if he can see them, and in spite of the trouble of standing in a queue before the cashier's desk he prefers to draw his dividends himself. A personal fortune deposited in a bank, of which he only gets news every six months in a balance sheet, is an abstract form of property that does not appeal to him. And since he keeps the papers and draws the dividends, it follows of necessity that he also keeps the money they yield in his own drawer or cash-box. So instead of a productive deposit you have unproductive hoarding.<sup>1</sup>

Since a deposit represents a debt of which payment may be demanded at any moment, it is obviously a dangerous business for the bank, for if it wants to make the deposited money bear fruit, it runs the risk of not having it in its possession when the depositor comes to claim it.<sup>2</sup>

But this risk is certainly not a sufficient reason for preventing banks from utilizing the capital deposited with them, and compelling them to keep it intact as a true "deposit," as the old banks of Venice and Amsterdam did. Everyone would be worse off if this stringent method were enforced.

In the first place, the depositors themselves would suffer, for it is evident that if the bank had to keep their money in its vaults without using it, it would certainly not be able to pay them any interest. On the contrary, it would have to charge them with the expense of keeping it safe — which is precisely what the old banks used to do.

Secondly, the country also would suffer, for the social function performed by banks is that of collecting the capital that would remain unproductive as pocket money or as a reserve fund, and converting it into an active and productive form. Now it would ob-

<sup>1</sup> Since the war, however, the French *rentier* has altered his habits in this respect, and has learned to make use of banks. So the amount of deposits has increased more than threefold, and new banks are being opened at every street corner.

<sup>2</sup> The risk involved in the repayment of deposits is even more dangerous than in the case of bank-notes, because the repayment of deposits is certain: it is certain that sooner or later the deposit will be claimed from the bank, whereas it is by no means certain or even probable that the repayment of a bank-note will be demanded. Most notes circulate until they are worn out without ever being brought to the bank for payment, and a great number never come back at all.

viciously be impossible for them to do this if they could not use their deposits.

Consequently banks do not hesitate to employ the sums of money entrusted to them. They merely take care to retain always a certain cash *reserve* to meet any demands that may arise. It is impossible to establish *a priori* any fixed proportion between the amount of this reserve and that of the deposits. The less the bank's credit and the greater the number of its large deposits, the more considerable should be its reserve, and it ought above all to strengthen its reserve in times of commercial crisis, and when State bonds and other securities are about to be issued — in short, whenever it foresees that depositors will need their money.'

### III. CHEQUES

When a depositor wishes to withdraw his money, what does he do? If he likes, he can simply go to the bank and receive it; but when the "credit habit" has been acquired there is a different mode of procedure. He obtains a *cheque-book* from the bank — a book containing a certain number of leaves and counterfoils printed with the requisite form in which he can insert the sum that he wishes to withdraw or to pay to someone else. Here he will write his own name if he wishes to draw the money himself, or the name of the payee, as the case may be, or even no name at all, if the cheque is a "bearer" cheque — that is to say, payable to anyone who holds it.

The invention of this simple little instrument of credit has effected nothing less than a revolution in economic matters. It tends, indeed, to make money unnecessary, as we have shown above (p. 236). For what purpose do we actually need money? Simply to pay our expenses. But cheques are precisely the most convenient method of paying all expenses, for all that is needed is to write a sum of money and a name on a slip of paper, tear it out of the cheque-book, and send it to one's creditor or tradesman, or as a subscription to some charitable society, or to the tax-collector, and so forth. In England and America the habit of using cheques is so widespread that a rich man never has any money on him or in his house. There

<sup>1</sup> To lessen the risk involved in taking deposits, most banks grant a higher rate of interest to depositors who are prepared to deposit their money for a certain minimum period — six or twelve months, or even five years.

On the day when war was declared in 1914 the government thought it was its duty to decree a *moratorium*, or a postponement of repayment. This measure was intended to prevent a panic, but it was an unfortunate step to take, for it risked destroying credit in order to save the banks. Moreover, the banks would have stood the shock well enough, and there would have been no panic.

is an oft-repeated anecdote that relates how some robbers plundered a millionaire, and were balked by finding on him only 27 cents, besides the inevitable cheque-book.

In France, however, though cheques are freely employed in business, they are very little used to-day in the payment of everyday expenses, and the efforts made to educate the public in this respect, especially since the war, have not yet had any considerable effect.

The reason for this is that cheques certainly have their drawbacks, though these are easily remedied.

(1) To begin with, anyone who receives a cheque has to take the trouble to go to the bank to cash it, and is it not natural that he should prefer to be paid directly by his debtor? That is certainly the case in France, and it is one of the chief obstacles to the extension of the cheque system. But it is not the case in a country where everyone has a current account at a bank — the man who receives a cheque as well as the man who sends it. In this case the creditor or tradesman who receives a cheque does not take the trouble to cash it, but sends it to his bank, which undertakes to cash it and to place the amount to the customer's credit.

(2) Secondly, a cheque may be lost or stolen. That, indeed, is a risk it shares with the bank-note, but there is a means of guarding against it which is not possible in the case of the bank-note. This is the method of the *crossed cheque* — a cheque having two parallel lines drawn obliquely across it. Not only can this cheque be paid only at a bank, like all cheques, but the money can *only be received by a banker* — by the banker who is expressly named between the lines of the crossing; or, if the drawer has not inserted his name, then the creditor who receives the cheque will insert the name of his own banker; but, however it is done, the cheque can only be presented to the debtor bank by another bank. Now the curious thing is that the banker whose name appears on the cheque never receives the amount of it in money; he always uses it in settling his accounts with his fellow-bankers. The crossed cheque, therefore, can only be used for payments by the method of compensation. So it has been humorously defined as a cheque that is intended never to be paid. A German law of 1908 even allows the drawer absolutely to forbid the payment of a cheque in cash, by marking it "payable by compensation," or "to be carried to account." The advantage of this kind of cheque is that it cannot be used by anyone except the banker whose name it bears: consequently it matters little if it be stolen or lost, for the wrongful owner would not know what to do with it — unless we suppose the thief to be in league with the banker who is

to receive the cheque, and that he has the effrontery to induce him to place it to his credit! But even in this case the fraud would be quickly discovered.<sup>1</sup>

(3) Lastly, and above all, there is the risk that the cheque may not be paid on presentation because the drawer has dishonestly neglected to deposit sufficient funds to meet it, or has withdrawn them before the presentation of the cheque.

What can be done to avert or mitigate this danger? The law must punish as a fraud the act of drawing a cheque without having sufficiently *provided* for it, as the legal term goes. That is what the legislator has decided to do in France, but only by the recent law of the 22nd June, 1917. The war, in fact, has made it imperatively necessary to try to reduce to a minimum the number of notes in circulation, and consequently to increase the use of cheques with that object.<sup>2</sup>

But what is particularly required is a standard of public morality sufficiently high for the act of remitting an uncovered cheque to be regarded as a dishonourable one, entirely discreditable to the man who is guilty of it. That is why the extension of the cheque system in any country should be considered a mark of economic education and advanced public morality.<sup>3</sup>

A good many conditions must be fulfilled, therefore, if the cheque system is to become universal in any country, but the one primary and essential condition is the habit of depositing money in the bank. In this case alone can the cheque bring about the economic revolution to which we have referred — namely, the elimination of cash payments. This revolution is already on the way in England and America. All the bankers in these countries are debtors and creditors of each other for enormous sums, and so their London and New York agents have nothing to do but to balance their accounts. That is done every day when they meet together in the *Clearing House*. This is an institution of long standing in England, for it dates from 1773. Transactions are settled there, by the simple

<sup>1</sup> There is a tendency nowadays for cheques to take the place of bills of exchange. This is unfortunate, for it means the suppression of an admirable instrument of credit which enabled the manufacturer to renew his capital continually.

<sup>2</sup> [The mere drawing of a cheque without having provided for it does not appear to be an offence in English law.]

<sup>3</sup> The extension of the cheque system among persons not given to reflexion may, however, become a dangerous stimulus to expenditure, for when any fancy can be gratified by the mere signing of a slip of paper it is easy to yield to the temptation. The sight of the money that is paid away is a restraining influence that is absent in this case.

method of compensation, which amounted before the war to nearly sixteen thousand million pounds a year, and in 1920 to over 39 thousand millions<sup>1</sup> — more than a hundred millions a day. Metallic money, and even notes, appear only as an insignificant balance. It is plain that the value of all this paper money rests ultimately on a metallic basis. But every day this foundation becomes narrower and narrower, relatively to the enormous edifice of credit built upon it. It is, as has been said, like a growing pyramid standing on its apex, or a top revolving with dizzy speed on a motionless metal point, and in such conditions equilibrium seems terribly unstable. For once the top ceases to revolve, it falls!

#### IV. DISCOUNT

When this capital has once been borrowed by the bank at a low rate, the next step is to turn it to account by lending it to the public.

But how is this to be done? We have just seen that the banker cannot lend it for long periods, in the form of mortgages, for instance, or in financing industrial undertakings,<sup>2</sup> for he must not forget that this capital is only deposited with him, and he may be compelled to refund it at a moment's notice. Consequently he can lend it only for short periods, so that he is not deprived of it for long, but keeps it to some extent within reach and under his own eye.

Can we find any loan transactions that fulfil these conditions? There is one that fulfils them admirably. When a merchant sells his goods, according to trade custom he allows the purchaser a certain amount of time in which to pay. If, therefore, he is in need of money before the time for payment arrives, he must have recourse to his banker. The latter advances him the sum due for his goods, deducting a small amount which constitutes his profit, and gets in return the merchant's bill of exchange on the purchaser. The banker keeps this bill until the date when it falls due, and then collects it from the debtor. He thus recovers the capital which he has advanced.

This transaction is called *discounting*. It is a form of loan, for it is obvious that the banker who, in exchange for a bill of exchange for £1000 payable in three months, advances £985 to the merchant while waiting to receive £1000 from the debtor when the bill falls due, is in reality lending his money for three months at the rate of

<sup>1</sup> [The figure given by the author is "over 28 thousand millions"; but this is too low — the actual total for 1920 was £39,018,903,000.]

<sup>2</sup> Cheques are not discounted, as they are payable at once, or after a short interval. Consequently the substitution of cheques for bills of exchange, to which we have already referred, would have the unfortunate effect of abolishing this credit operation.

6%, or even rather more. These loans are always for short periods, for bills of exchange negotiated by bankers are not only payable as a rule in three months at the outside, but that period is a maximum one which is not often reached. Traders do not always need to negotiate their bills the very day after they have sold their goods; they may keep them for a time, and may not even need to negotiate them till just before they fall due. At the Bank of France, for instance, though the maximum legal period of delay is 90 days, in practice it is much less, and the average time during which bills remain is scarcely more than three weeks. So it is only for a very short time that the banker is deprived of the money deposited with him, since every pound returns to the bank after a short interval.

It will be apparent that if demands for the repayment of deposits are spread over a period of three or four weeks, this will enable the banker to be always in a position to meet them, owing to the return of the money he advances. Now it is very unlikely that demands for repayment of deposits will be as frequent as this, at any rate in normal circumstances. It would be difficult, therefore, to find a loan transaction that is better suited to the requirements of the deposit system. No doubt if all depositors conspired to claim their money on the same day the banker would be unable to meet their demands, for his money — or rather, *their* money — would be travelling all over the world. It would certainly not be slow in coming back, but there is always this difference between the capital borrowed by the bank in the shape of deposits and that which it lends by the method of discount, that the first can be claimed *immediately*, while the second can only be demanded *after a certain lapse of time*. And this difference may, at any given moment, involve the failure of the bank.

It remains to be added that not only is discounting a convenient method of lending, but that it is also extremely safe, on account of the joint liability of all the cosignatories. In fact there is not merely a single debtor — the *drawee*, as he is called — but always at least two, for in default of the drawee, the *drawer* is liable. Moreover, if he passes the bill of exchange on to a third person, this person also becomes liable in case of non-payment. So the position is the same as if the debtor had as many sureties as there are holders of the bill, including the one who issued it. Consequently, the more a bill circulates the more signatures it bears — sometimes it needs an additional sheet of paper to take them — and the better is its value guaranteed.<sup>1</sup>

<sup>1</sup> [A dozen lines dealing with the procedure of the Bank of France have been omitted from this section.]

## V. THE FOREIGN EXCHANGES

The word "exchanges," which used to frighten examination candidates, has become familiar to everybody since the war, as it has been so constantly heard. It may be defined as *the art of settling debts between two countries without the use of money.*

The portfolios of all great banking houses, at least of those that transact business abroad, are crammed with bundles of bills of exchange and cheques payable in all the great financial centres of the world — London, New York, Milan, and so forth. They represent values amounting to thousands of millions of pounds, and are the object of a very active trade. They go by the generic name of *paper.*

The bankers who own these things and deal in them are evidently only intermediaries or middlemen. We must ask, therefore, from whom they buy this commodity, this paper, and to whom they sell it.

From whom do they buy it? From those who produce it — all those who from any cause are creditors of foreigners, but especially those *English merchants who have sold goods abroad*, and who, as a result of these sales, have drawn bills of exchange on their debtors in Paris or New York, or have received cheques on Paris or New York from them in payment.

To whom do the bankers sell this paper? To all who need it — and there are plenty of them. This paper is eagerly sought after by all those who have payments to make in foreign countries, and especially by *English merchants who have purchased goods abroad.* The reason is this: in law every claim is payable in the creditor's country. Anyone, therefore, who has bought goods in America is obliged to send the amount of the purchase price in dollars to his creditor's country — which is not a convenient proceeding, nor even always a possible one, for the debtor may happen to be in a country where American money is not obtainable. But if he can manage to procure paper payable in dollars on the exchange of the country where his creditor lives — bills on New York — he will send that instead, and that will provide him with a more convenient and less costly way of paying his debt. This method is called *making a remittance.*<sup>1</sup>

<sup>1</sup> It will be easily understood that the debtor in need of a draft cannot always find one payable exactly where his debt is due, especially in the case of a place with which his country has few business relations — say Algiers, for instance. But such a slight hindrance will not worry him. He will buy a draft on Paris, and send it to his Algerian creditor, who will use it to pay for his purchases in France, or in any case will find no difficulty in getting it discounted.

This double exchange operation is called *arbitrage.* Its object is not only to facilitate



It seems as if this paper ought to be sold, or negotiated, at a price that is always equal to the sum of money that it represents. A bill of exchange or a cheque for £100 ought surely to be worth exactly £100 — neither more nor less. Yet this is not the case. It goes without saying, in the first place, that the degree of confidence that can be placed in the signature of the debtor, and the period of time that must elapse before the date of payment, may affect the value of the bill. But apart from these self-evident causes of variation, even supposing that the paper is perfectly reliable and payable at sight, still its value will vary from day to day according to changes in supply and demand, like the value of any other commodity. These variations constitute what is called the *rate of exchange*, which is quoted in the newspapers like the Stock Exchange quotations.

It is easy to understand what is meant by supply and demand as applied to commercial securities. Suppose that our credits abroad, due either to our exports or to any other cause, amount to five hundred million pounds. Suppose, further, that our debts abroad, due to our imports, or our borrowings, or any other cause, amount to a thousand millions. In this case it is clear that there will not be enough paper for those who want it, since the total supply will not exceed five hundred millions. All those, therefore, who require these bills in order to pay their debts will bid against each other, and foreign bills will rise in value; that is to say, a bill for £1000 payable at New York, Paris, or Berlin, instead of selling for £1000, will sell for, say, £1005. Such paper is, as the term goes, *above par*: it rises to a *premium*.<sup>1</sup>

payment by compensation, as in the case just mentioned, nor is it only a resource for debtors in difficult circumstances. It constitutes a special and very profitable branch of commerce, which consists in buying exchange where it is cheap, *so as to sell it again where it is dear*. Arbitrage brokers spend their time at the telephone, enquiring for the rate of exchange between different places.

Arbitrage has the interesting effect of extending facilities for payment by compensation to all countries. Which are the countries where paper on foreign places is dear? Those in which debts exceed credits, and which, therefore, can only settle their accounts by way of compensation. But by means of the paper that the arbitrage brokers try to procure abroad — and which they will obtain from places in the opposite situation, where the claims are greater than the debts, for only there will they find paper cheap — they will be able to restore the equilibrium and settle the whole of the country's debts by compensation. And the result of this intercourse between all the markets is that paper on any country whatever sells everywhere at very much the same price.

<sup>1</sup> The calculation is really more complicated than this, because in most cases — in practically every case where England is concerned — the currencies of the debtor and creditor countries are different. We must first ascertain the *par value* of the foreign money compared with the English pound — that is to say, its value according to

Conversely, if our credits abroad amount to a thousand million pounds, while our debts abroad are only five hundred millions, it is obvious that paper will be superabundant, since there will be a thousand millions of it available, and the payment of our debts will absorb only five hundred millions. Many bills, therefore, will find no purchasers and will only be able to be utilized by sending them abroad for collection. Hence the bankers will strive to get rid of them by selling them even below their face value. Thus a bill for £1000 on Paris will sell perhaps for £995: it will fall *below par*.

Whenever in any country paper payable abroad is quoted above par, the exchanges are said to be *unfavourable* to that country. What is meant by this expression? For it must be observed that if the rate of exchange is unfavourable to buyers, it must, conversely, be favourable to sellers. This is true; but what the term really means is that in these circumstances the rate of exchange indicates that the claims which this country has against foreign countries are not sufficient to counterbalance our debts abroad, and that consequently we shall have to *send a certain amount of money abroad* to make up the difference. The rise of the rate of exchange, otherwise called dearness of paper payable abroad, is therefore an infallible premonitory sign of an export of coin, and it is for this reason that we speak of an "unfavourable exchange." Conversely, whenever in this country foreign paper is quoted below par, the exchanges are said to be *favourable*. The process of reasoning in this case is just the same: a fall in the price of foreign exchange indicates that when all reckonings are made the balance of accounts will be to our credit, and we must therefore expect the arrival of coin from abroad.

We must not, of course, attach too much importance to these words "favourable" and "unfavourable." We know that for a nation to have to send money abroad or to receive it from other countries constitutes neither a great danger nor a great advantage, for its wealth does not depend on the amount of money it possesses. But from the bankers' point of view this situation is of very great importance, for if money has to be sent abroad it is from their funds that it will be taken. All the premonitory signs, therefore, are of capital importance to bankers, who have their eyes constantly fixed on the rate of exchange. This rate is quoted in all the papers, the weight of gold it contains. Thus the franc is worth 9½d., the dollar 4s. 2d., the mark 11½d., the rouble 2s. 1½d., and so forth. In exchange quotations a conventional unit is taken, for the sake of simplicity: a pound in England, and 100 marks, or 100 crowns, or 100 pesetas, as the case may be, in other countries. Then, by comparing the rate of exchange with the value of the monetary unit at par, we can see and measure at a glance the extent of the deviation from the par value. (See below, p. 304.)

especially to-day when so much interest is taken in it. Exchange quotations may well take their place alongside of the weather report, and might even be represented graphically, like the meteorological observations, by a curve showing the variations in the rate. This would be very appropriate, since the exchanges are the barometer of finance. Like the actual barometer, they indicate rain and fine weather; but we must be careful to read them in the opposite direction. When the barometer rises, it means fine weather, and when it falls, it means rain; but when the rate of exchange rises — that is to say, the price of bills payable abroad — it means bad weather, because it means that gold is going to leave the country. When, on the other hand, the exchanges are low, we may expect sunshine, for the gleam of gold is forecasted!

It must be observed, however, that variations in the price of exchange are confined to much narrower limits than those of ordinary goods. In normal times this price can never be quoted very much above or very much below par.

Why, indeed, does a merchant who owes money abroad seek bills of exchange? Simply to save the expense of sending coin and changing his money into foreign money. But it is very obvious that if the premium that he has to pay to obtain a bill is higher than the cost of sending and converting coin (which is not, on the whole, very great), he will have no reason for buying a bill. Moreover, the merchant who is a creditor of foreigners, or the banker who acts as his intermediary, only negotiates these bills of exchange so as to anticipate the date of payment. He will not consent to sell them at a price much lower than their real value, but will rather wait patiently until the debtor sends him the money, as he is bound to do.

In short, then, since dealings in paper have no other object than to save the cost of transporting coin from one country to another, it will easily be understood that such dealings must lose all justification as soon as they become more burdensome than the operation of sending coin — that is to say, as soon as the variations in the price of exchange, above or below par, exceed the cost of sending coin. Now this cost, even including insurance, is very small: consequently, fluctuations in the price of exchange are also very small.<sup>1</sup>

The term *gold point* is given to the rate of exchange at which it

<sup>1</sup> At the same time, in the case of a very distant place, or one with which communication is not easy, the cost of sending specie becomes much greater, and variations in the price of bills of exchange may also be much more marked. It is clear that a merchant who had to make payments at Pekin or Khartoum would think himself very lucky if he found bills on these places, even if he had to buy them much above their nominal value. But such cases are of little importance.

becomes more economical for a debtor to send coin than to buy bills of exchange. This *gold point* is very important to the banker, for it marks the moment at which the export of gold becomes profitable, and so he must expect this gold to be sought for at the bank, in the shape of demands for the payment of bank-notes.<sup>1</sup>

In normal times these variations are not only of slight extent but they also tend to correct themselves. In fact, as soon as bills on foreign countries are at a premium, the result is an extra profit for all who have them to sell — that is, for exporters. So this state of affairs is a great stimulus to exportation. But the increase in exports will result in a reversal of the balance of trade, making it favourable; and in this way equilibrium tends to be automatically restored, as we have already seen. If bills on foreign countries are below par, the same process takes place, but in the opposite direction.

All this, however, is ancient history at the present moment, for since the war we have seen the rate of exchange fluctuating everywhere in an extraordinary fashion, and without any tendency towards the restoration of equilibrium. Thus, at the moment of writing, the rate of exchange on Paris whose par value is 25f. 22½c. to the pound, is quoted at 56f. 82½c.; exchange on Brussels, with the same par value, is quoted at 60f. 35c.; exchange on Italy (par value 25.22½ lire to the pound) is quoted at 102½ lire, and so forth. This means that bills on foreign countries are worth to-day in our money only a half or a quarter of their old value. And, conversely, since if one scale of a balance rises the other must fall just as far, it means that in Paris, Brussels, and Rome, the pound is worth about 45s., 50s., and 82s. respectively.<sup>2</sup>

The causes of this phenomenon, which is upsetting international relations so profoundly, are numerous. Three of them are:

(1) The depreciation of paper money, already described. This has been enormous in Russia, Austria, and Germany, and has also occurred, though to a smaller extent, in France, Italy, and Belgium.

<sup>1</sup> There are necessarily two gold points, corresponding, as it were, to the two poles: one above par, marking the moment when specie goes out, and one below par, marking its point of entry.

<sup>2</sup> Exchange on the countries of Eastern and Central Europe (Germany, Austria, and Russia) is even more favourable to England, for the mark, the crown, and the rouble have fallen far lower than the franc and the lira. Thus 100 marks, which used to be worth nearly £5 at par, are quoted to-day at about 4d.; 100 Austrian crowns (par value £4. 8s. 4d.) are to-day worth about two-thirds of a penny; and the rouble, having lost all its value, is not even quoted at all.

[The examples and figures in this section differ from the author's, as he naturally uses French exchange rates, which are less favourable than ours.]

(2) The disturbance of equilibrium in the balance of trade and the balance of indebtedness, as explained at the beginning of this section. One reason why the exchanges are so unfavourable to France and other countries is that their debts to foreign countries, and especially to the United States and England, have increased enormously, partly because of loans contracted to pay war expenses and partly owing to their imports of food stuffs and raw materials.

(3) Speculation.<sup>1</sup> Bank-notes are sought after by financiers hoping for a rise in the value of the franc or the mark, and thrown back on the market when they are afraid of a further fall.

Why cannot equilibrium be restored to-day as in normal times? Because nearly all the means of settling these debts are wanting. France, for instance, cannot send gold, since she has not enough even to cover her enormous issue of bank-notes; nor can she send goods, for owing to the depletion of her stocks, and shortage of raw materials and labour, she can scarcely produce enough for home consumption, and certainly has no surplus for exportation.

## VI. BANK-NOTES

The interest of a banker, like that of every other merchant, lies in increasing the extent of his transactions as far as possible. Twice as much business means twice as much profit. How, then, can a banker extend his operations?

If he could create capital out of nothing, in the form of coin, instead of having to wait patiently until the public is willing to entrust it to him, this would certainly be a most advantageous proceeding so far as he is concerned. Indeed, since it was several centuries before the public got into the habit of bringing their money for deposit, bankers conceived the ingenious idea of creating the capital they needed, without waiting for it, by issuing simple promises to pay — *bank-notes*. And experience has shown that the idea was a good one.<sup>2</sup> It has succeeded admirably.

In exchange for the commercial paper which is presented for discount, the banks can therefore give their notes instead of gold or silver. But it may seem surprising that the public should accept

<sup>1</sup> The main cause of exchange variations since the war has been the depreciation of paper money and the unbridled speculation which has resulted from it. When the mark or the crown fluctuates by hundreds of points in the course of a day, it becomes a mere gambling instrument, like the roulette ball at Monte Carlo; men gamble on the chances of recovery or bankruptcy of the country in question.

<sup>2</sup> This ingenious invention is attributed to Palmstruch, the founder of the Bank of Stockholm, in 1656. But the financier, Law, was the first to issue bank-notes on a large scale (1721), though his system ended in disaster.

this arrangement. Here, for instance, is a business man who comes to the bank to get a bill of exchange for £100 discounted, and he receives in return for it a bank-note for £100 — in other words, he simply receives another credit instrument. “What use is this to me?” he may ask; “I want money, not instruments of credit. If I only get credit in exchange for credit, I might just as well have kept the bill I had to start with!” But if he reflects a moment he will see that although the bank-note is only another credit instrument, like the bill of exchange, it yet represents an infinitely more convenient kind of credit, since it is equivalent to money. It is superior to other credit instruments, and especially to bills of exchange, for the following reasons:

(1) It is *transferable to bearer*, just like a piece of money, whereas a bill of exchange is subject to the formality and the liabilities of endorsement.

(2) It is *payable at sight* — that is to say, at any time one pleases. This is proclaimed in black and white on every bank-note, even to-day, whereas commercial paper is payable only at a specified date.

(3) It *always remains payable*, whereas other credit instruments lose that privilege after a certain period of time.

(4) It is *for a round sum*, in agreement with the monetary system of the country — £5, £10, £20, £50, and so on — whereas other credit instruments, being the result of commercial transactions, generally have a fractional value.

(5) It is *issued and signed by a well-known bank*, whose name is familiar to everybody, even to the general public who are ignorant of business matters, such as the Bank of England or the Bank of France, whereas the signatories to a bill of exchange are generally known only to those who have business relations with them.

All these considerations lead the public to accept a bank-note as if it were ready money, since it can always be exchanged for money.

It is true that the bank-note is inferior to the bill of exchange in one important respect — that it yields no interest. But even this is rather a mark of superiority, for if the bank-note yielded interest its value would fluctuate, like that of a bill of exchange, according to the nearness or distance of the date of payment. Now that is just what it must not do. A bank-note is not capital, as long as it is in circulation: it is money. What is important, therefore, is that its value should be as invariable as that of money.

But if the fact that a bank-note yields no interest is no drawback to the holder of it, it is a very great advantage to the bank. For it can thus obtain capital on far more advantageous terms than in the

form of ordinary loans or even deposits, since these generally cost 1% or 2%, as we have seen, whereas the bank-note costs nothing but the expense of manufacture, which is very slight.

At the same time, if the issue of bank-notes is of great benefit to the banks, it goes without saying that it may also give rise to serious dangers. In fact, the amount of notes in circulation, which may at any moment be presented for payment, represents a debt that is payable on demand, just like a deposit. Consequently, the bank is exposed to a twofold peril: it may be called upon at the same time to *repay its deposits* and to *repay its notes*.

If the necessity for a cash reserve exists even when the bank has to meet only the demand for the repayment of its deposits, it is still more urgent when it adds the debt resulting from its note circulation to that which results from its deposits payable on demand. Hence we can understand why the law of several countries compels banks, when they wish to issue notes, to keep always a certain reserve.<sup>1</sup> When there is no such law, prudence enjoins the same thing.

## VII. DIFFERENCES BETWEEN BANK-NOTES AND PAPER MONEY

In an earlier chapter (Book II, Chapter IV) we studied paper money and explained why and within what limits it can take the place of metallic money.

Paper money properly so called is paper which not only has no specie behind it, but which does not represent any promise to pay, at least at any definite date. It is generally issued by a State for the simple reason that it has no other resources, so in these circumstances it cannot make any promise to pay it back in gold or silver. It is as well to confine the name "paper money" to this kind of currency.<sup>2</sup>

Upon what, then, does its value depend, since it rests neither on a metallic basis nor on credit? Simply on the currency conferred upon it by law — on the fact that it performs the functions of money, and that there is no other money to take its place, so that it cannot be dispensed with.

This kind of paper money is current in many countries in the form

<sup>1</sup> See Section IX, below.

<sup>2</sup> [The French language draws a convenient distinction, which English does not, between *monnaie de papier* and *papier-monnaie*, the latter being the kind described in this paragraph. We might distinguish the two kinds as *convertible* and *inconvertible* paper money respectively.]

of Government or Treasury notes, and the war gave birth to many varieties of it.

The bank-note, when issued in normal circumstances, differs from paper money in three particulars:

(a) The bank-note is always repayable — always *convertible into gold or silver* at the pleasure of the bearer, whereas paper money is not. The latter has all the appearance of a promise to pay a certain sum, and as a matter of fact we may hope that the State will one day be more fortunately situated and able to cash its notes; but this more or less distant prospect can scarcely affect those who receive the notes, for they have no intention of keeping them till then.

(b) Bank-notes are issued *in the course of commercial transactions*, and only to the extent required by these transactions, generally for a value equal to that of the bills of exchange presented for discount; whereas paper money is issued by the government for the purpose of meeting its expenses, and hence its issue has no other limits and no other check than the financial necessities of the moment.

(c) Lastly, as their name indicates, bank-notes are issued *by a bank* — that is to say, by a private undertaking whose main object is to carry on commercial operations and whose principal care is to safeguard its credit. Paper money, on the other hand, is always issued by the State, and even if the State cares for the public interest it does not always find that a sufficient check.

But if such are the normal characteristics of bank-notes so long as they remain "fiduciary money," they may happen, in exceptional circumstances, to assume the character of paper money, properly so called.

Bank-notes may belong to the category of representative money, if the reserve fund that guarantees them is equal to the value of the notes issued. This occurred in France ten years ago, and in England it is the rule. There the amount of notes issued may only exceed the amount of the metallic reserve by a relatively small margin, which is itself covered by safe securities; and this rule was kept even during the war.

But, on the other hand, the bank-note may enter the category of conventional paper money — paper money properly so called. We must distinguish several phases in this unfortunate transformation.

It may happen, to begin with, that the bank-note acquires *forced circulation*, which means that it ceases to be convertible, at any rate for a time. This has happened very often, in times of crisis, to the notes of nearly all the great banks. Care must be taken not to confuse legal tender with forced circulation. A note is legal tender



*when creditors or sellers cannot refuse to accept it in payment.* It has forced circulation *when the holder cannot demand its repayment in money at the bank.* Forced circulation always presupposes legal tender, but the converse is not by any means true. Bank-notes have always been legal tender in France, but they had no forced circulation until the war. Everyone was bound to accept them, but everyone could have them converted into gold at the Bank of France, just as he pleased. To-day forced circulation is the rule in almost every country except England.

At the same time, even in the case of forced circulation, there still remain the two other differences between bank-notes and paper money that we have just indicated, and especially the second one: namely, that the quantity issued is not indefinite and arbitrarily fixed, but is regulated by the needs of trade. This is a very important source of security.

But it is possible that this guarantee may also disappear — the bank-note may not only acquire forced circulation, but may be issued with the sole object of making advances to the State to enable it to pay its expenses, instead of being issued in the course of commercial transactions. Such is the position in many countries to-day. The governments, being in need of money, say to the banks: "Make us notes for as many millions as we shall choose, and lend them to us, and we will exempt you from the obligation to repay them by giving them forced circulation." In this case the issue of notes has no other limit than the needs of the State, and so the bank-note, it must be confessed, bears a strong resemblance to paper money.

Yet, even then, it differs from true paper money or State notes, and the difference lies in the personality of the issuer. This by itself is enough to make the bank-note much less liable to depreciation than true paper money. Experience has proved this so abundantly that States have generally given up the direct issue of paper money and have had recourse to the banks instead. The public, indeed, thinks that the banks will resist as long as possible any excessive issue that is urged upon them, for that means ruin for them, and it believes (not, alas, without reason) that the solicitude of a financial company that has to look after its own interests, is more watchful and tenacious than that of a government or finance minister who has only the public interest to consider.

Since the bank-note is the equivalent of money, its superabundance has the same effect on prices as a superabundance of metallic money (see above, p. 199). That is the phenomenon visible to-day through-

out the world, and known as *inflation*. No doubt it would be incorrect to regard the unlimited issue of bank-notes as the sole cause of the enormous rise in prices, for there are many other causes. Yet if we draw the curves of prices and note issue, they will be found to run almost parallel. The public attributes the rise simply to the scarcity of products and the difficulties of transport, which is true enough in itself, and fails to perceive the hidden cause — the depreciation of paper money — particularly since governments strive to conceal or to deny it, so as to keep the credit of the note intact. Nevertheless it becomes difficult to hide this cause when the rise in prices gets beyond a certain point.

Inflation, then, appears as the gravest evil from which Europe is suffering, and all financiers, statesmen, and economists are striving to find a remedy for it. It seems a very simple matter: surely you have only to bring down the number of notes in circulation to its pre-war figure? But to destroy the millions of notes issued in excess would mean that the banks would first have to repay them, and that would involve the repayment by the States of the millions they have borrowed from the banks. Of course they have expressly promised to do this as speedily as possible, but they need so many millions for other purposes — if only, as in France, for the restoration of the devastated regions — that it is doubtful whether much will remain to repay the banks.<sup>1</sup>

Moreover, even if this repayment were feasible it would be very dangerous, for this sudden rarefaction or deflation of money would cause a fall in prices and a terrible crisis. It could only be accomplished by degrees.

### VIII. RAISING THE RATE OF DISCOUNT

There is a case in which banks run the risk of having to pay a great quantity of their notes. This is when it is necessary to make heavy payments abroad. As these payments cannot be made in notes, but only in coin, the debtors have to appeal to the Bank to convert their notes into cash.

If, in consequence of a bad harvest, we have to buy a couple of million tons of wheat abroad, that means that a sum of, say, £40,000,000 must be sent to America, and the Bank must reckon on the greater

<sup>1</sup> [So far as repayment to the banks is concerned, this paragraph applies in particular to France. The position in England is different, since here the State itself has undertaken the issue of currency notes instead of delegating it to the Bank of England. But the evil effects of inflation are of course the same in either case.]

part, if not the whole, of this sum being drawn from its supplies. The vaults of the Bank, as we have seen, are the reservoir in which most of the floating capital of the country comes to be accumulated in the form of coin, and the only one that can be drawn upon in case of emergency. That is a situation that may become dangerous to the Bank if its reserve, and especially its gold reserve, is not very large. Fortunately it receives early warning of the situation by an even surer indication than the barometer gives to the sailor — namely, the rise of the rate of exchange to the critical point, the *gold point* (see p. 304). If, in fact, the exchanges become unfavourable — if foreign paper is negotiated above par — the Bank must draw the conclusion that debtors having payments to make abroad are too numerous, much more numerous than those who have payments to receive, and that consequently, since everything cannot be settled by the method of compensation, the balance must be sent abroad in cash.

Even without supposing a rise in the rate of exchange, the progressive increase in the amount of commercial paper, coinciding with a decrease in the amount of the cash reserve, indicates a disquieting situation.

When the danger is thus foreseen, the Bank proceeds to take precautionary measures. To guard against the contingency of having to make too heavy payments it must take the necessary steps either to increase its cash reserve or to diminish the number of its notes in circulation.

It is not exactly in the power of the Bank to increase its cash reserve, but it does rest with it to put no more notes into circulation — that is to say, to *make no more loans to the public*, either in the form of advances or in the form of discount; and since it is by these two operations that the bank puts its notes into circulation, it is plain that its object will be perfectly attained by this means. For, on the one hand, when the issue of notes is stopped, the quantity already in circulation will no longer increase; and, on the other hand, as the commercial bills in the Bank's portfolio successively fall due, they bring back to the Bank every day a considerable quantity either of notes (thus diminishing the number in circulation) or of coin (thus increasing the reserve).

The quantity of notes in circulation may be compared to a stream of water in a set of pipes, entering by one tap and issuing by another, so that it is constantly renewed. The flow of notes enters into circulation by being issued by the method of discount, and, having circulated, enters the bank again in the form of collections and de-

posits. Now if the bank turns off the "issue" tap and leaves the other one open, obviously the circulation will soon dry up completely.<sup>1</sup>

Nevertheless, the complete cessation of all advances and of all discounting business that we have just supposed, would be too stringent a measure. It would provoke a terrible crisis in the country by suppressing all business operations and all profits. But the Bank may bring about the same result in a less violent manner by merely restricting the amount of its advances and its discount business. To accomplish this it is sufficient either to raise the rate of discount, or to be more particular about accepting paper that is offered for discount, especially by refusing bills whose date of payment is too distant, or that bear signatures which do not seem sufficiently reliable.

Undoubtedly such a measure, even when applied with moderation, is scarcely agreeable to business men — and the less so because it makes it harder for them to obtain cash at the very moment when they need it most. The method has even been accused of provoking crises, and we can readily believe it. It is a heroic remedy, but for that very reason it is the right one in the circumstances, and a prudent bank must not hesitate to resort to it to defend its reserve. Its efficacy has been abundantly proved by experience.

Not only, moreover, does this method have happy results for the bank, by warding off the blow that threatens it, but it has beneficial effects on the country itself by modifying its economic situation in a favourable direction. Suppose that this country is threatened with having to make large payments abroad. A rise in the rate of

<sup>1</sup> Suppose, for example, that the Bank has on hand a million pounds' worth of commercial paper, that it has a cash reserve of a million pounds, and that it has notes in circulation to the value of two million pounds.

In these circumstances it is evident that if, as the result of a panic of some sort, all the holders of notes came to the Bank and demanded their immediate redemption in specie, the Bank would be unable to comply. But as soon as the Bank has reason to fear such an eventuality, all it will have to do is to cease discounting bills. This is what will happen then: the bills of exchange in the Bank's portfolio fall due one after the other, so that the sum of a million pounds returns in ninety days at the outside, and on an average much sooner than this (see p. 299). What will the situation have become by that time? If this million has been paid in cash, the bank will now have two millions in cash, which is just the amount of its notes in circulation. There is therefore no cause for alarm. If the million has been paid in notes, that leaves only a million notes in circulation, which is just the amount of the cash reserve; so there is still no cause for alarm. If the million has been paid half in cash and half in notes, then the Bank will have £1,500,000 in its cash reserve, and the same amount of notes in circulation, and in this case too there is nothing to fear. It is the same with any other imaginable combination of circumstances.

discount, effected at the right time, reverses the situation by making the country a creditor of foreign countries for considerable sums, and thus gives rise to an influx of money from abroad, or at least prevents the outflow of its own supply of money.

What takes place, in fact, is this. The first result of a rise in the rate of discount is a *depreciation of all commercial paper*. A bill of exchange for £100 which sold for £97<sup>1</sup> when the rate was 3%, will only be negotiated for £93 when the rate has risen to 7%. This is a depreciation of more than 4%. Henceforth the bankers of all countries, and especially those who transact arbitrage business,<sup>2</sup> will not fail to purchase this paper here, because it can be bought here at a low price. They will thus become our debtors to the extent of the sums they devote to these purchases.

The second result is the *depreciation of all stock exchange securities*. Every financier knows that the stock exchange is greatly affected by the rate of discount, and that a rise in the rate almost always entails a fall in the value of stocks. This is because stock exchange securities — especially those that are called *international* because they are quoted on the principal stock exchanges of Europe — are often employed by business men, or at least by bankers, in place of commercial paper,<sup>3</sup> to pay their debts abroad. As soon as they see that they cannot get money for their commercial paper, or that they can only do so at a heavy loss, they prefer to get funds by selling whatever stocks or securities they possess. Hence these also fall in value, following the movement of commercial paper. But just as the fall in the value of paper attracted the demand of foreign bankers, so the fall in the value of stock exchange securities gives rise to increased purchases of them by foreign capitalists, and thus the country becomes the creditor of foreign nations to the extent of the considerable sums they devote to these purchases.

Finally, if the rise in the rate of discount is great and sufficiently prolonged, it will produce a third result — *a fall in the price of all commodities*. We have just said that business men in need of money begin to obtain it by negotiating their commercial paper, and that

<sup>1</sup> To make the problem simpler, we assume that the discount is calculated for a period of one year.

<sup>2</sup> See above, p. 300.

<sup>3</sup> If you have a payment to make in Paris, for example, the simplest plan, no doubt, is to obtain commercial paper payable in Paris; but you can equally well use Italian Debt coupons, Lombard Railway debentures, Ottoman Bank bonds, Transvaal or Rio Tinto mining shares, and so forth, which are also payable in Paris. These things constitute a real international money and are continually used in that capacity (we are speaking, of course, from a pre-war point of view).

if this resource fails or becomes too costly, they fall back on any stock exchange securities that they may possess. But finally, if they have come to the end of their resources, they must, in order to get money, sell or "realize" the goods they have in stock. Hence arises a general fall in prices. But this fall, again, produces the same effects, and on a larger scale — that is to say, it stimulates purchases from abroad, and thereby increases our exports and makes us a creditor of foreign countries.

All these effects can be summed up by saying that *a rise in the rate of discount creates an artificial scarcity of money,<sup>1</sup> and thereby produces a general fall in values of all kinds.* This is undoubtedly an evil. But it also gives rise, as a consequence, to *considerable demand from abroad and consequently to the importation of money.* This is a good thing, and precisely the remedy that fits the situation.

It must not be thought that the war, although the most terrible of crises, caused an enormous rise in the rate of discount. For it must not be forgotten that the banks of all countries are sufficiently secured by their exemption from liability to cash their notes, as well as by the embargo on the export of gold. They have no need, therefore, to safeguard their reserves by having recourse to the defensive measure of raising the rate of discount. However, a rise in that rate would have had the good effect of diminishing inflation, and thereby indirectly diminishing the rise of prices, and it is a pity that the banks did not apply the brake more strongly.

## IX. THE ORGANIZATION OF BANKS

The question of the freedom of banks, as it is called, used to hold an important place in treatises on political economy. It includes two different questions, and it is important that these should not be confused.

### I. *Monopoly or Competition*

The first question is this: Is it better to have only one bank endowed with the privilege of issuing notes, or to leave this power to be exercised by all banks under certain conditions?

On this point there is scarcely any discussion now. If free competition can render great services in the case of goods, it is different in the case of the issue of national money, which is what bank-

<sup>1</sup> We call this scarcity *artificial*, but it corresponds all the same to a reality, or at least to a contingency that tends to be realized, namely, the flight of money to foreign countries. The evil is cured by a similar evil: it is the method of the homœopathic school of medicine — *similia similibus*.

notes are. It even seems as if this function ought to be a privilege reserved for a State bank, just like the right of coining money. So the general tendency is to confine the privilege of issuing notes, if not to a State bank in the strict sense of the term,<sup>1</sup> at all events to a bank which is placed under State control, like the Bank of France.

Even when the monopoly of issuing notes is not legally established, and when the right of issue is assigned to several banks, as in the United States and even in England, there is a tendency towards monopoly in actual practice. Although the right of issue is still exercised in the United States by more than 7,000 local banks (which are none the less called *national banks*), it has been confined in practice, since 1913, to twelve great federal banks. In England, when the banks that have kept the right of issue cease to exist — for banks are not immortal, any more than men — or when for any reason they give up their right of issue, they are not replaced, and the Bank of England succeeds to their privilege.<sup>2</sup>

As may well be imagined, this tendency towards monopoly is not regarded with favour by economists of the liberal school, especially if the monopoly is exercised by a State bank, properly so called. If it were merely a question of the issue of notes, if the State bank were to be simply a factory for manufacturing notes, like a mint, then they would readily accept it. But the socialist or radical-socialist advocates of State banks have no intention of reducing them to the position of mere offices for the issue of notes. They want to "go the whole hog." They want State banks for the very purpose of fighting against what they call the financial oligarchy. They want them to have a cash reserve to be used as a State war chest, and with the power over the whole movement of business that is given by the right to fix the rate of discount. So here again we meet with the well-known arguments against the unsuitability of the State for the exercise of industrial functions, and especially of the very delicate function of a controller of credit.

What the opponents of State banks say is this:

(1) That a State bank would necessarily bring political considerations into its business, far more than commercial ones, and that it would never refuse to discount the paper of influential friends of the government but would often refuse that of its opponents.

<sup>1</sup> A "private" bank is one whose capital is provided entirely by shareholders, and which therefore belongs to them and is governed by them. If, on the contrary, a part or the whole of the capital is provided by the State, the bank is partly or wholly a State bank.

<sup>2</sup> [See footnote to p. 323, below.]

(2) That it would be forced to get credit with the public by financing all movements of social reform.

(3) That it would never be able to refuse to lend to the State, and that consequently it would be at the mercy of the State, and induced to make ill-advised note issues ending in the depreciation of the note.

(4) That if the State and the bank were one, the credit of the State would be far from benefiting the credit of the bank. On the contrary, in times of crisis, the credit of the bank would suffer from the shock to the State.

(5) Lastly, that in case of an unsuccessful war, the victor, who has hitherto respected private banks,<sup>1</sup> would have no reason to respect a State bank and would regard it as lawful prize.

If the monopoly is entrusted to a *private bank*, as is the case in England and France, these arguments do not apply, even if the bank is controlled by the State. But the liberal school has certain criticisms to make against this system as well. The monopoly of one bank, even if it is confined to the issue of notes, puts the competing banks, in fact, into a position of unfair inequality, for it confers upon the note-issuing bank the right of discounting bills with notes that cost nothing. Thus in France the monopoly of note-issue has given the Bank of France such pre-eminence that it has made all other banks its vassals. The Bank of France is congratulated on having always kept its rate of discount at a more moderate level than other banks. But there is no great merit in that, since the discounting is done with notes that cost the Bank nothing but the cost of paper and engraving.

This is true — so runs the reply of the advocates of monopoly, — but the Bank of France renders a great service to the other banks in freeing them from the duty of keeping any cash. For these banks, instead of keeping a supply of idle money, procure it from the Bank of France when they need it, and so the Bank of France acts as their treasurer. It is the banker's bank.<sup>2</sup> And it needs an enormous reserve to enable it to play this part. This leaves it only a small margin for the issue of notes, and therefore for any exceptional profit, especially if we take into account the numerous charges imposed by the State as the price of this privilege. Moreover, the right of issuing notes arouses little jealousy abroad, as is shown by the fact

<sup>1</sup> Thus Germany respected the branch offices of the Bank of France during the war of 1870-71.

<sup>2</sup> [The Bank of England holds a similar position in relation to the other English banks.]



that many banks in Germany and England that still enjoy the privilege, are voluntarily abandoning it.

To sum up, then, the monopoly of note issue conferred upon a single bank — a private bank, but under State control — seems to be the best solution, at any rate in practice. This ideal is realized in the organization of the Bank of France, which has been put to the proof for a hundred years and has come triumphantly through many political and economic crises.

## 2. Regulation or Freedom of Issue

Here we have a different question. The freedom of banks, in the sense of free competition between them, is one thing; freedom in the sense of freedom to issue notes at their own discretion is another. Not only does the first not necessarily imply the second, but we might even say that where freedom of competition exists among banks the regulation of their note issues is most stringent — as we shall see in the case of the United States — and where monopoly is most completely realized the control of note issues is the lightest, as we shall see in the case of France. This apparent contradiction is easily explained, for it is obvious that the greater the number of note-issuing banks the more dangerous it is to give them a loose rein.

In the palmy days of the liberal doctrine — that is to say, in the middle of the nineteenth century — it was an admitted principle that all legal regulation of issue was useless because freedom, here as elsewhere, was perfectly sufficient. That is what is called the *banking principle*, as distinguished from the *currency principle*, to be considered shortly, according to which the circulation of notes should be determined entirely by the quantity of cash held by the bank. The contest between these two principles is famous in economic history, and occupied a large place among the controversies of the first half of the nineteenth century.

Let us examine the thesis of the *banking principle* — that of freedom of issue. What is the danger to be feared from *laissez faire*? An excessive issue of notes? This danger is imaginary, it is said; the mere play of economic laws will confine the issue within reasonable limits, even if the banks wish to exceed them, for the following reasons:

(1) To begin with, bank-notes are only issued in the course of banking operations — that is to say, in discounting and making advances on securities. If a bank-note, therefore, is to enter into circulation, it is not enough for the bank to wish it to do so: there must also be someone disposed to borrow. So it is the needs of the public

and not by any means the desires of the bank that control the issue of notes. *The quantity of notes that a bank will issue will depend on the amount of commercial paper offered for discount, and the amount of this paper will itself depend on the state of business.*

(2) Secondly, bank-notes only enter into circulation for a short time; they return to the bank a few weeks after they have been issued. Here is a note for £100 issued in exchange for a bill of exchange. But in a few weeks — in 90 days at the outside, — when the bank collects the bill, the £100 note will return. It will not be the same note, but what does that matter? As many as go out, just so many come back.

“What the flood took, returns upon the ebb.”

(3) Finally, even admitting that the bank can issue an excessive quantity of notes, it would be impossible for it to keep them in circulation, for if notes are issued in too abundant quantities they will necessarily depreciate, and *as soon as they depreciate, to however slight an extent, the holders will hasten to bring them back to the bank to demand payment.* It would be useless, therefore, for the bank to try to flood the public with notes, for it could never succeed, but would instead be flooded with them itself.

This is one of those arguments that are incontestable in theory but dangerous when applied in actual practice.

It is true that the quantity of notes issued depends on the demand of business men and not on the will of the bank. It must be observed, however, that if an unscrupulous bank aims only at attracting customers, it can always, if it lowers its rate of discount sufficiently, imprudently increase the number of its customers by taking them away from other banks, and thus increase also the amount of its note issue.

Again, it is true that the notes issued in excessive quantities by this imprudent bank will return for payment as soon as they become depreciated. But depreciation does not make itself felt instantaneously: it will not be felt for several weeks, perhaps. And if during this time the bank has continued to throw into circulation an excessive number of notes, when they at length return it will be too late. The bank will no longer be in a position to pay them, and will be drowned by the returning tide that we spoke of before. It is true that the bank will be the first to be punished for its imprudence by insolvency. But what is the use of that? Our business should be to prevent the crisis and not to punish the authors of it.

Absolute freedom of issue assumes, therefore, as a preliminary condition, that banks should be prudent. And if this prudence

can be counted on in the case of a single great bank that has proved itself, it would be unwise to take it for granted as applying to all banks.

That is why the system of absolute freedom, without any regulation as to the issue of notes, is not in force anywhere.

The systems of regulation that have been employed in different countries may be classed under four heads:

(1) *Limitation of the amount of notes in circulation to the amount of the reserve.* In this case the bank-note becomes merely representative money to take the place of gold. It offers complete security, but, on the other hand, it has scarcely any utility, except that of taking up less room in the pocket than gold and saving the wear and tear of metallic coin. The bank thus ceases to be a credit establishment: it is no longer a bank, but simply a strong-room — a mere treasury that serves for making payments and keeping a reserve of money for contingencies. Consequently this system is not applied anywhere in its full rigour, and we only mention it for logical completeness.

(2) The second process consists in fixing either a certain *margin* or a certain *ratio between the amount of the reserve and that of the notes in circulation.*

A margin — that is to say, the difference between the reserve and the circulation, or the uncovered balance, as it is called — is fixed *ne varietur*. This is the rule adopted for the Bank of England, as we shall see later.

A ratio, or fixed proportion established once for all, is generally one-third. But it is purely empirical, and the figure varies in different countries.

The system of the ratio is somewhat more elastic than that of the margin. But they both lead to the same result: at a certain moment they make all discounting and even all payment of notes impossible, and consequently create the danger that they seek to prevent. Suppose the reserve stands at five millions and the number of notes at fifteen millions: the bank is just within the prescribed limits. But at this point it cannot pay a single note more without causing its reserve to fall below one-third of the amount of notes — for 4 is not a third of 14. So the rule has to be suspended, even under this system.

(3) The third method consists in simply fixing a *maximum for the issue of notes, without fixing any minimum for the reserve.* This is the system that is applied to the Bank of France. The maximum was fixed before the war at 6,800 million francs (say £270,000,000).

But there is no fixed minimum for the reserve, even in normal times. Although all examination candidates persist in declaring that the reserve has to be one-third of the amount of notes, this is not the case at all, and the Bank might allow its reserve to fall to zero. To tell the truth, there is some excuse for disbelieving in the existence of such a system. For it is obvious that a maximum note issue is absolutely useless as a guarantee of payment of the notes if no minimum is fixed for the reserve. It must be acknowledged, however, that notwithstanding this paradoxical system — a maximum for note issues, but no minimum for the reserve — the Bank of France in normal times has always had the prudence to keep its reserve at an excessively large ratio to its circulation rather than otherwise, and this fact is obviously the strongest argument that can be adduced in favour of the principle of freedom — the banking principle.

(4) A fourth system consists in obliging the banks to *secure their note issues by means of reliable instruments of value*, representing a value at least equal to that of the notes.

If the securities chosen to serve as guarantees are government bonds, as was the rule in the United States until 1913, this is a bad system, for it is not in the power of a bank to realize them immediately. But if these safe securities that have to serve as cover for the bank-notes might be bills of exchange — that is to say, short-dated securities, — as is now permitted by the American law of 1913, then these might be regarded as a real guarantee, though insufficient in themselves. It should be observed, however, that such a condition is not, properly speaking, a method of regulation: it is merely a return to the system of freedom, for the characteristic feature of the banking principle, as we have just said, is simply that the issue of notes is sufficiently regulated by the discounting of bills of exchange.

To sum up, it must not be hoped that any conceivable system can absolutely guarantee the payment of notes. Banks, indeed, are and must be *credit* institutions. If we wish to use credit we must put up with its inconveniences: to try to combine the advantages of credit with those of ready money is like trying to square the circle, for the one excludes the other.

At the same time there is reason to think that a bank that occupies a unique position in the country, strong in its traditions and its majesty, and realizing its responsibility, will use all necessary prudence in the issue of its notes. Experience has confirmed this view in the case of most of the great banks, and especially in the case of the Bank of France, whose organization has been put to the proof

for more than a century and has come triumphantly through many political and economic storms. It seems, then, if we rely on the teaching of experience, that the best solution is a monopoly of note issue entrusted to a private bank, under State control, but with the minimum of regulation.

## X. THE GREAT BANKS OF ISSUE

We cannot examine the banks of issue of every country (see my *Political Economy*), but we cannot neglect to study the working of the two that support the whole edifice of credit in France and England.

### 1. *The Bank of France*<sup>1</sup>

The Bank of France is a century younger than its great sister, the Bank of England, having been born on the 13th February, 1800. It was created by Napoleon, and remains, along with the Civil Code, the greatest of the civil monuments he has left.

The Bank of France is not a State bank, as is sometimes thought. It is a private bank, constituted, like every joint-stock company, with capital provided by the shareholders, and governed by a board of directors elected by the shareholders. Since 1806, however, its independence has been seriously impaired by the nomination by the State of its governor and two deputy governors.

The Bank's right to issue notes dates only from 1803, and the privilege is accompanied by certain conditions. These are as follows:

(1) The Bank may only discount bills of exchange that bear three signatures (to guard against all risk of insolvency), and that are drawn for 90 days at the most.

(2) None of its customers, except the State, may overdraw their accounts. The Bank may make advances to anyone, however, on certain kinds of securities, or on bullion.

(3) It may not pay any interest on deposits.

Such are the statutory regulations. But there are two more stringent ones that were added later:

(4) A maximum is now assigned to the issue of notes, which was free until 1870. This maximum has been constantly raised since that date. From 1,800 million francs in 1870 it rose step by step to

<sup>1</sup> [This section is somewhat abridged, by the omission of details of little interest to the English reader.]

6,800 millions before the war, and since the war it has reached 43,000 millions (say, £1,700,000,000).<sup>1</sup>

(5) The State has imposed various contributions upon the Bank, including a permanent loan of 200 million francs (£8,000,000) without interest, and a share in its profits in the form of a royalty calculated upon the note circulation and the rate of discount. This amounted before the war to some 15 millions (£600,000) a year, and is now more than double this figure.

This monopoly of the Bank of France, like all monopolies, has had to meet many attacks, and has given rise to acute controversy. But the Bank renders very great services to the State. In cases of emergency it puts at the disposal of the government not only the bullion stored in its vaults but also an almost unlimited supply of notes, issued according to the needs of the State. During the war it lent the enormous sum of 27 thousand million francs (£1,080,000,000) to the State, besides nearly four thousand millions (£160,000,000) to its allies. This advance was made at a rate of less than 1%, when the State was borrowing from the public at 6%, thus making a saving of more than £40,000,000 in interest.

The Bank of France also renders a service to the other banks. Instead of competing with them, it exempts them from the duty of keeping a gold reserve, and thus enables them to make use of all the funds at their disposal. When these banks need money they simply get the Bank of France to *re-discount* the bills they have themselves discounted. All they need, therefore, to be prepared for any contingency, is to have a sufficient supply of paper that fulfils the conditions necessary for it to be discounted by the Bank of France.

Thus the great credit establishments are free to devote themselves entirely to the profitable business of discounting, subscribing loans, and so forth, without any great anxiety about repayment. They have all the advantages of the banking business and hardly any of its liabilities.

## 2. *The Bank of England*

The constitution of the Bank of England differs in many respects from that of the Bank of France.

<sup>1</sup> Since the war the ratio between note circulation and reserve has naturally altered considerably. The return for the 7th September, 1922 gives the following figures:

Notes in circulation.....	36,959 million francs		
Gold in hand.....	3,534	"	"
Silver ".....	286	"	"

Proportion between bullion and note circulation, 15.75%.

(a) It is entirely a private bank, belonging only to its shareholders, and as such it is self-governed, except as mentioned below. It is therefore completely independent of the State.<sup>1</sup>

(b) It has a less absolute monopoly of issue than the Bank of France. It is only in London that it has the exclusive privilege of issuing notes: there are provincial banks which also issue notes. At the same time the number of banks with the right of issue is *rigorously limited*, and since 1844, the date of Sir Robert Peel's famous Bank Charter Act, those that disappear may no longer be replaced. Their number, which was 279 at that date, grows smaller every year, so that the Bank of England, which already enjoys a virtual monopoly, will soon be invested with a monopoly in law, as the legal heir to all deceased provincial banks.<sup>2</sup>

(c) It is subjected to a far more rigorous control in the matter of note issue and cash reserve. The amount of notes issued must never exceed the sum of the amounts of the reserve and the capital. This capital, however, only consists for the most part of a credit on the State that is not available and cannot be utilized. It is better to say more simply that the note issue may only exceed the cash reserve by a fixed amount, which is now £18,450,000 — a poor margin, it is obvious, for such a bank as the Bank of England.

With a view to ensuring the keeping of this rule, the Bank is divided into two distinct departments: the *Banking Department*, which undertakes the ordinary banking business of deposits and discounts, but may not issue any notes; and the *Issue Department*, which issues notes but does no other business. The Issue Department delivers its notes to the Banking Department simply in accordance with the needs of the latter; and when it has handed over £18,450,000-worth it can deliver no more except in exchange for coin or bullion.<sup>3</sup>

This automatic limitation of issue gives rise, precisely in times of crisis, to such great inconvenience that on three separate occasions

<sup>1</sup> ["The Bank of England is only a state bank in the sense that it is the bank with which the government keeps its accounts. The issue department, however, may be considered as in effect a government office, like the mint." (Nicholson, *Elements of Political Economy*, p. 293.)]

<sup>2</sup> Whenever one of the other note-issuing banks comes to an end [or relinquishes its right of issue] the Bank of England may increase its note issue up to two-thirds of that of the bank that has disappeared, but it must deposit an equivalent sum in securities.

[The monopoly of the Bank of England became complete in 1921, when the last provincial bank of issue forfeited its privilege.]

<sup>3</sup> [The working of the Bank of England is shown most clearly by a study of the *Bank Return* that is issued every week in accordance with the terms of the Bank

already — in 1847, in 1857, and in 1866 — it has been necessary to suspend the law and allow the Bank to overstep the fatal limit.<sup>1</sup>

On the day of the declaration of war in 1914, the Government had an anxious time. There was a run on the Bank and the reserve fell on the 4th August to below £10,000,000. Ought the Act to be suspended? Everything was ready for that step. But the Government heroically refused. They preferred to have recourse to a different method: they had notes issued by the State — currency notes, or Treasury notes, for £1 and 10s. — repayable not in gold but in bank-notes. And at the same time they prohibited the export of gold. The panic subsided without its becoming necessary to resort to forced circulation, and to this day England is the only one of the ex-belligerent countries — at least in Europe — where the bank-note is still convertible into gold.<sup>2</sup>

Charter Act. The following is the Return for the week ending November 1, 1922.

<i>Issue Department</i>	
Notes issued . . . . .	£144,052,400
Govt. Debt . . . . .	£ 11,015,100
Other securities . . . . .	7,434,900
Gold coin and bullion . . . . .	125,602,400
Silver bullion . . . . .	
<u>£144,052,400</u>	<u>£144,052,400</u>
<i>Banking Department</i>	
Capital . . . . .	£ 14,553,000
Rest . . . . .	3,128,144
Public deposits* . . . . .	15,034,269
Other deposits . . . . .	108,844,733
Seven-day and other bills . . . . .	20,780
<u>£141,580,926</u>	<u>£141,580,926</u>
Govt. Securities . . . . .	£ 50,604,553
Other securities . . . . .	68,189,891
Notes . . . . .	20,893,560
Gold and silver coin . . . . .	1,832,922

The first part of this table shows plainly how the total note issue is covered to the extent of £18,450,000 by documentary securities, and the rest by gold coin and bullion. For every note issued in excess of this £18,450,000 (which is the amount to which the original £14,000,000 has grown since 1844 by the lapsed issues of provincial banks) the corresponding value in specie must be deposited in the Issue Department. A certain proportion of this specie reserve (one-fifth) may consist of silver, this provision having been made in view of the trade with India.]

\* Including Exchequer, Savings Banks, Commissioners of National Debt, and Dividend Accounts.

<sup>1</sup> [This necessity for the suspension of the Bank Charter Act in times of crisis has given rise to the saying that the Act is of no use until it is suspended. But it does not at all follow that the principle of limitation is unsound because it has to be removed in cases of emergency. "In fact," says Professor Nicholson, "it may be said that in this country we have a constitutional elastic limit for the issue of notes." (*Elements of Political Economy*, p. 308.) But the whole question has given rise to endless controversy, both before and since the passing of the Act of 1844.]

<sup>2</sup> That is, in principle. In practice it is not convertible, but no one has any interest in changing bank-notes into gold, for what use would it be, since it is forbidden either to export the gold or to melt it down?