

CHAPTER IX

Money and Banking (Continued)

A BRIEF REVIEW OF HISTORY AND A QUICK GLANCE AT PRESENT USAGES.

Money is not the same thing as wealth. Wealth is an accumulation of property, which may be, but need not be, expressed in money. Money is a medium of exchange . . . created out of the necessity for some common denominator of value.

When a man had accumulated a little hoarded gold or silver . . . it became impossible to carry it all about with him, and dangerous to leave it lying around so what did he do? He went to the richest man in the community, who had probably built himself a strong-box, and asked whether he would be good enough to keep the gold for him. The rich man agreed, accepted the gold, gave his receipt for it—and so became the first banker.

Now see what happens. John Thrifty goes home with the signed receipt of Old Strong-box . . . Mrs. Thrifty persuades John it would be nicer to own their own home than to have a lot of gold . . . They find the house they want, make their bargain, and John Thrifty shows the other man Old Strong-box' receipt. The other man says: "Don't bother to get the gold. I don't want it lying around. You come with me to Strong-box and we will get him to tear up your receipt and give me one instead." Off they go to Strong-box but Strong-box says: "It's not necessary to write a new receipt. You take Thrifty's receipt, after Thrifty has written his name on it." That is done and there we have the first paper money.

—JAMES P. WARBURG in
The Money Muddle
Permission Alfred A. Knopf

SOME of the monetary principles discussed are well illustrated in our own early history. Although the South was settled generally by an English element, very similar in social and economic status to the New England Yankee, the types of living which developed were quite different, perhaps because of differences in soil, climate and systems of land tenure. While the New Englander developed generalized and small-scale farming, and a certain degree of industrial life, often in almost self-supporting agriculture, the Virginian, because of the possibilities offered by tobacco culture, held large plantations manned by slave labor and concentrating on big-scale money-crops, especially tobacco. The Southerner gave less thought to manufacturing and commerce: he was content to sell his tobacco in the English market where he bought most of his supplies. The Yankee, on the other

hand, either purchased these things locally or made them himself.

In the South concentration on tobacco as a crop, as an export and as a source of revenue, made this the great staple, and it became the money of the colony. Contracts, prices, and salaries were generally in pounds of tobacco, and this was further favored by the fact that Virginia had very little of any other kind of money and less coin than did her northern neighbors. Often too, the Virginian lived extravagantly and on long-term credit, and he often owed considerable sums to his English factors and agents, to whom his tobacco was consigned and from whom he bought most of his supplies.

Such a system had grave disadvantages. Largely because of the shortage of what we call "hard money," Virginia resorted to paper currency; and, as is nearly always the case under such circumstances, it was over-issued beyond possibilities of redemption. Consequently it fell in value and passed only at a heavy discount. Finally England was compelled to prohibit the printing of paper money and British creditors demanded payment in coin or English currency, often impossible.

If it was a bad tobacco year, everybody was in trouble, and if it was a big tobacco year, the crop brought low prices. In a crisis the Virginians undertook to make payment in currency, of salaries to the clergy of the established church, contracted for in tobacco, since tobacco had risen to such a price that payment in tobacco would have been far in excess of what was regarded as just. After litigation and a great deal of trouble, things were adjusted, and these salaries were paid in cash; but this goes to illustrate the difficulties which result from an unstable or uncertain currency or from two currencies trying to exist side by side.

Another result of this monetary problem in Virginia was that business was conducted very largely by barter. Freeman's life of Washington gives the story of some of the trading which Washington did. He ran a successful forge and repaired implements for his neighbors, taking payment in all kinds of commodities, even in services, including medical care for his slaves. On one occasion a large bill was settled by deeding him a piece of land. This method of doing business is cumbrous and often unjust, but there seems to be no other course when the money system fails.

The subjects of money and banking are closely interlocked. Aside from the paper money already described, formerly most

banks issued what were called "bank notes"—paper bills of the familiar sort resembling national notes. Until the passing of the national bank legislation, these bills passed more or less current but often at considerable and varying discounts. Those who handled money subscribed to a periodical, called the *Banknote Reporter*, which reported on the condition of each individual bank; and, before accepting the notes of any bank, they would study its standing. Frequently the holders of such notes got caught because the bank had failed. This condition was remedied by federal legislation requiring banks to keep on deposit, as a guarantee of these issues, a certain proportion of federal bonds, and after this legislation these notes generally passed without discrimination.

Bills of this sort are no longer current—why, does not now matter—but paper of similar character is in constant use and by it are probably settled about 90% of our business transactions. These papers are what we commonly call checks—written orders to a bank, where the man issuing the check has a balance on deposit, to pay out of that balance a stated sum to payee. The dollar bill is a convenient way to transfer ownership of the dollar held by the Treasury; so we use checks to transfer credits with the bank; and, just as the government is seldom called upon to deliver the silver dollar pledged by its note, so too the bank seldom pays the cash for which the check calls but simply makes bookkeeping entries. The essential thing generally is not to hand over actual money, for which the check calls, but to have it available if the new owner demands it. All this "credit money," meaning paper money which is little more than a promise, brings us to the subject of banking. By far the greater part of our business transactions are based on bank credits; so, before going further, give a little thought to banks, what they are and how they operate.

Modern banking was largely developed in Holland and Venice and had origin in the custom of leaving money and valuables with goldsmiths and jewels for safekeeping. Banks are primarily depositories for money. Few wealthy men keep their fortunes around the house to be stolen, destroyed by fire, or, perhaps just lost. Every day we read of ignorant or over-suspicious persons, who, distrusting banks, come to grief through foolish handling of money. Sometimes they carry it about with them and lose it or are robbed. Sometimes they hide it in a mattress, a wastebasket, or among old clothes, and then forgetfully destroy it or give it away. Sometimes paper money is hidden between

the pages of books thoughtlessly sold to an old-book man, and often fortunes are buried or hidden about the house, their hiding-places forgotten; and, when the only ones in the secret die, fortunes are lost.

Besides taking care of money, banks serve another very useful purpose—they invest our money for us. What do we mean by investment? Investment is the purchase of capital, and its object is to permit our accumulated funds to earn interest. We often think of cash on hand or a balance to one's credit as capital, but money is not capital until it is spent in purchasing or creating true capital, the tools of production. This may seem a fine distinction, but it is important, for we should remember that money does not earn interest until invested, or loaned to one who will use it profitably, and this is exactly what the bank does for us with our money.

There are many ways in which we can invest our savings directly, but often the individual, and especially one of limited means, will do better to deposit his funds in a bank and let the bank do the investing for him. For this there are three reasons.

First, the banker, trained in the business, has better opportunities and can invest more wisely than can many an individual. Second, the funds of the individual are often so limited, perhaps saved in small sums each week, that it is almost impossible to invest enough at one time satisfactorily and profitably. By depositing our money in the bank, it is pooled with similar small amounts belonging to many others, and it is all invested together, to the advantage of everybody. Third, the individual often is doubtful of leaving his funds invested for very long. He may want to "uninvest" them, so to speak, selling his capital for cash to provide for current needs. There may be sickness, death, loss of jobs, a hundred things; perhaps he wants to buy a house or to educate his children.

Often investments which an individual may make cannot be readily converted into ready cash, or, if they can, not always on favorable terms. It may, therefore, be wiser to deposit our funds in a bank where many such small deposits are united and in the aggregate form a respectable sum: then, when a depositor finds himself in need of cash, he can draw out his money, which has very little effect upon a great reservoir of money being poured into the bank all the time, invested, loaned, paid back and perhaps drawn out, but seldom with many depositors making heavy drafts at the same time.

Banks are of two kinds, the commercial banks, often called

banks of discount, and savings banks. In the former, you draw out funds deposited or pay them to others, by writing and signing a check, which is a formal order to pay from your account a stated sum either to you yourself, if you want cash, or to another to whom you wish to make a payment. This is a great convenience and far safer than carrying money or sending it through the mails. A properly drawn check is, generally, a valid receipt for payment made; after the checks which you have signed circulate and are paid by your bank, they are returned to you, endorsed by those to whom they were payable; and these endorsements constitute an acknowledgement of payment.

This handling and bookkeeping means labor and expense to the bank; and, generally, instead of paying the depositor a share of the interest which his money earns, he is compensated by the services which the bank renders. Today, with interest rates low and expenses high, banks often find that small checking accounts cost more to handle than they earn, for trivial balances cannot earn enough in interest to cover bookkeeping and handling costs. Accordingly many banks analyze the cost of caring for each account, giving consideration to the average balance in the account and handling costs, based on the number of deposits made and checks drawn. Then, if the account does not pay for itself, a service charge is made each month. Generally, if a depositor keeps a good balance on hand, the bank makes no such charge and stands ready to render many valuable services, making loans, arranging for funds for travel, advising on investments, and similar services.

These banks belong to stockholders, and are operated for profit. Their investments are generally largely in loans to depositors, usually "short term" loans running only a few years or perhaps months or even days. In many businesses, even those which are very successful and profitable, it is often necessary to borrow considerable sums for a short time. The manufacturer must buy raw materials and meet payrolls, often for many months before he can sell his goods and collect payment. Flour is sold throughout the year, but it may be wise to buy wheat and mill it when the new crop comes on the market. Similarly, textile companies must often borrow to buy wool or cotton to be sold as cloth, or perhaps as garments, months later, and frequently a retail store ties up considerable sums in its stock in trade.

Such operations are often financed by bank loans, the note of the borrower being discounted. If he wants say \$10,000 for four months at 6% he will give the bank a promissory note for

that amount and they will credit his account with \$9,800, which is the value of the note less four months interest. This actually makes the rate a bit higher than 6%, for he pays \$200 interest, not on \$10,000 but on \$9,800, but this method of "bank discount" is generally accepted and approved.

If the borrower has unquestioned standing, he may get the loan on a simple promissory note, but often there is security pledged—"collateral" we call it—and even those of highest standing generally get better terms on a "secured" loan than on one that is unsecured. If he owns stocks or bonds, he may deposit these with the bank, with a formal paper authorizing their sale if the terms of the loan are not met, or he may pledge a warehouse receipt for the wheat, or perhaps a bill of lading if it is still in transit to him. These documents give the bank a claim on the wheat, and lending money in this way is often the source of much of the bank's profits. Such banks, having a constant flow of money in and out, depositors turning in money, borrowing money, repaying money every day, must always be prepared for sudden calls for funds. Therefore, most of their investments are "short term" investments, meaning that they are loans of short duration with a quick turnover of funds.

Bankers soon found that generally no large amounts of money were drawn out by many depositors at the same time; and often, when a man received a check on the bank instead of demanding money, he preferred to leave the proceeds of the check to be held to his credit in the bank. Thus this business of making what looked like cash drafts on the bank became actually the mere transfer of credits on the books of the bank, bookkeeping and not cash transactions. The bankers found, therefore, that often it was possible to loan far more money than was actually deposited with them, for what the borrower generally wanted was not cash but credit; and, when a loan was negotiated, instead of giving the borrower the money, they generally placed it to the credit of his account in the bank. Thus the banks were enabled to make loans far in excess of actual cash holdings, and it is in this wise use both of money and credit that successful banking lies.

It is not easy to draw a sharp line between money and credit, for often the latter serves exactly the same purpose as actual cash. There is really little difference between a check drawn on a bank for one dollar and a dollar bill. They are both orders to transfer one dollar that is on deposit somewhere, and the only real difference is that one is based on the credit of the United States

and the other on the credit of the signer of the check. Practically then what the bank handles, what it receives from its depositors and what a man borrows, is not cash but credit. It is a highly developed system—of great benefit and advantage; but it is also precarious, for one or two big financial failures may start a chain reaction with very far-reaching results, bringing disaster to many.

Savings banks are a different thing. In many states, but not in all, they are mutual banks, which means that they are owned by the depositors and operated only for their benefit. There are no stockholders and all profits accrue to the depositors. Deposits are not checking accounts, and drafts can be made only on the presentation of the bank book, which is the accounting which the bank makes to its depositors. Interest earned is the first consideration, as contrasted with the convenience and service rendered by the other banks, and it is credited to the depositors' accounts at fixed dates, either semi-annually or quarterly. Although generally spoken of as interest, it is technically a dividend; for the bank belongs to the depositors, and what is paid them depends upon the earnings of their money. These dividends are declared by the trustees at regular intervals; but this has become something of a fiction, for often these banks stabilize the rate at a safe point and treat it much more like interest than as dividends. Although the bank is the property of its depositors and has no stockholders, the depositors have no voice in management; the governing body, the board of trustees, is a self-perpetuating body, serving without pay and filling its own vacancies, and depositors have nothing whatever to say.

A savings bank, not being subject to checking, and often safeguarded from sudden demands in other ways, as by reserving the right to demand advance notice of all drafts from an account, can safely tie up its money in long-term loans, and generally a large part of the assets is loaned on mortgages and similar obligations.

All this has more to do with business methods than with economics, but it shows in what a variety of ways a bank can create credit which may be checked against and which increases the amount of money or its equivalent and thus promotes inflation, to be described in the next chapter. Credit so created is often a serious factor in inflation and frequently efforts are made to control inflation by restricting credit. A study of the Federal Reserve system and the way it operates in such situations is beyond the scope of this book. Practically it is a system of banking for banks, permitting individual banks to deposit a reserve with

the Federal Reserve Bank, and to borrow against this reserve; and then, by modifying the rate of interest, or the percentage of the deposit which can be borrowed, they can regulate the amount of available funds for lending by each bank. They thereby control, in a measure, the expansion of credit, and this matter of bank credit is important to our economy and has a direct bearing on the money, or its equivalent, in circulation.

QUESTIONS

What is a paper dollar?

What is a check?

Is there any essential difference between the two?

Are such papers as dollar bills or checks generally redeemed in coin? If not, what purpose do they serve?

Describe two kinds of banks. Wherein do they differ?

To which would you go for a mortgage loan on your house, to which for a loan to buy Christmas stock for a store?

What valuable services do banks offer their customers:

1. In the way of practical business service?
2. In opportunity for investment of idle funds?
3. In opportunities both to save and to borrow?
4. In what other miscellaneous ways?

How do banks increase the amount of credit in use?

Does this increase of circulating credit act much the same as increase in money?

If the amount of gold in the dollar is increased, will the dollar buy more or less? If it is decreased, what happens?

What would you say of three devices for increasing the amount of money in circulation: (1) the printing of paper money, (2) increased borrowing, (3) cutting the amount of the gold or adulterating it? Are the effects of all three policies similar?