CHAPTER VI.

BANK MONEY.

221. The Characteristics of Bank Money.—To secure the superior convenience of paper money, and, in a degree, also, its cheapness, as contrasted with money of metal, while retaining the comparative stability of value which characterizes the latter, and to keep the local circulation in such close communication with the general circulation of commerce as to insure the automatic regulation of the money supply, bank money has been invented.

The essential characteristic of such money is that the paper is instantly convertible, on the demand of the holder, into coined money. Whenever, by the unrebuked and unpunished lapse of the banks issuing paper money, as so frequently in the early history of the United States, or by the action of government upon its own initiative and for its own purposes, the money so issued fails to be convertible to the full extent indicated, it becomes inconvertible paper money. Nothing entitles paper to be called bank money except full, instant, unconditional redemption in coin. There is no stopping-place between this condition and inconvertibility.

Generally speaking, this sort of money is issued by institutions which, whether under State patronage or not, are so far disconnected from the government that their officers and agents can be sued in courts, and their assets and effects be attached for the recovery of the amount promised by the bank notes to be paid on demand. In this matter of connection with the State, however, there is found among banks, in one country or another, every degree from least to largest. In some instances the true character of bank money has been preserved in the case of institutions having what would appear a dangerously close connection with government.

222. The Origin of Bank Money.—Bank money in its modern form was first issued in Sweden, in 1658. The Bank of Scotland issued £1 notes as early as 1704, while the Bank of England did not issue notes below £20 prior to 1759. The issue of bank money, proper, did not begin in America until after the revolution, although nearly every colony had been, at one period or another, deluged with inconvertible paper money. The great bank money countries of to-day are the United States and the States of Northwestern Europe.

223. The Coin Basis of Bank Money.—We have said that, in addition to the superior convenience of bank money over coin, the motive for issue is found in its comparative cheapness. Banking experience has shown that a much larger denominative amount of notes can be kept in circulation than is held of specie for redemption.

On all this excess, the issuer of the notes derives a profit which is measured by the rate of interest on his loans, after deduction is made of the expense of maintaining the service. The metal thus displaced from circulation is exported, or melted down for use in the arts.

The advantage to the community of this saving in the cost of the money used in effecting exchanges, is thus conceived by Adam Smith.

"The gold and silver money which circulates in any country may very properly be compared to a highway, which, while it circulates and carries to market all the grain and corn of the country, produces itself not a single pile of either. The judicious operations of banking, by providing, if I may be allowed so violent a metaphor, a sort of wagon-way through the air, enables the country to convert, as it were, a great part of its highways into good pastures and corn-fields, and thereby to increase very considerably the annual produce of its land and labor."

The amount of saving effected by bank money varies, in the first instance, according to the proportion of coin, or "specie," as it is commonly called, reserved to meet demands for the redemption of the notes: to serve, that is, as the basis of the circulation.

That proportion is different in different countries, and often in different banks in the same country. The most common legal minimum reserve is one-third. In Leipsic, before the unification of Germany, the specie reserve was two-thirds, while in Bavaria it was but one-fourth.

Before the war of secession, the banks of the United States held an absurdly small amount of specie, the proportion in some States falling to ten, five, or even three per cent. But the so-called bank money of many of the States of the American Union, during certain periods in the early history of the nation, was really nothing but inconvertible money, hardly the pretense of redemption being maintained.*

224. The Banking Principle.—The view of the operations of bank money which is held by the great majority of writers of repute, in nearly all countries, is that, when really convertible into coin on demand; with all reasonable facilities existing for redemption, and with redemption actually taking place from time to time; with a public opinion which does not allow to be questioned the right of any man anywhere, for any reason or for no reason, to require coin, for any and all notes he may hold; and with exemplary penalties,† provided by law and enforced by the courts, for the first failure or the slightest delay on the part of banks to make good their promises, such money acts in all respects precisely as would a body of money composed wholly of coin. It is held to be fully subject to the law (par. 176) which governs the territorial distribution of money consisting of the precious metals only; and to have every economic virtue which belongs to such money, with the added advantage of greater cheapness and greater convenience in use.

"We are willing," says Mr. Tooke, the leader of the school of economists known as the advocates of the "Banking Principle," whose theory I have stated, "we are willing to consider a metallic currency as the type of that to which a mixed circulation of coin and paper ought to conform. But, further, we contend that it has so conformed, and must so conform, while the paper is strictly convertible."

The same opinion is expressed, with great emphasis, by Mr. Fullarton and Mr. James Wilson, and by M. Courcelle-Seneuil.

225. The Currency Principle.—The view of bank money which has been stated in the foregoing paragraph, is that which is held by a majority of writers of reputation. The opposite opinion was maintained by a school of economists in England, comprising the advocates of the so-called "Currency Principle," the leader of the school being Lord Overstone.

In the view of this school, something more than sound banking is needed to give a country good bank-money. If numerous, competing banks are left free to issue notes in such quantity and of such denominations as their own interests may dictate, with such specie reserves as their own prudence alone may suggest, there will always be the probability and often an extreme danger of over-issue, a body of bank-money so composed not being wholly amenable to the law of

* Mr. Condy Raguet thus describes the action of American banks during this period, when in a state of suspension:

"Banks, when they default in their payments, not only never ask the indulgence of their creditors, for any specified extension of time, but they do not even think themselves under obligation to pay interest to the creditors for the funds they forcibly detain from them; nay, they frequently, in the midst of their insolvency, declare dividends of the very profits which actually belong to their creditors."

Of an earlier period Mr. Gallatin has written: "It was the catastrophe of the year 1814 which first disclosed not only the insecurity of the American banking system, as then existing, but also that, when a paper currency, driving away and superseding the use of gold and silver, has insinuated itself through every channel of circulation, and become the only medium of exchange, *every individual finds himself, in fact, compelled to receive such currency, even when depreciated more than twenty per cent., in the same manner as if it had been a legal tender.*"

† "By convertibility of the paper," says Mr. Tooke, "according to the ordinary signification of the term when applied to bank notes in this country (England), is meant that a holder of a promissory note—payable on demand—may require payment in coin of a certain weight and fineness, and in the event of refusal or demur, such payment is enforced by law against the issuer, to the utmost extent of his property. *The issuer, whether a private or joint-stock banker, is considered to have failed.* The circulation of his notes is at an end, and he is subject to the process usual in cases of insolvency."—["History of Prices."] Compare this with the state of things disclosed by Mr. Raguet, in the foot-note last preceding.

distribution which governs metal money, but possessing the capability of temporary and local inflation.

This opinion was ably maintained by Lord Overstone, Mr. Norman and Colonel Torrens, against the views of the Bank of England, and after a long struggle, the economists of this school triumphed in the enactment of the Bank Act of 1844* which still governs the note-circulation of England, though the principle on which it was framed is now challenged by many of the best financiers and economists.

In the United States, owing doubtless to gross abuses of the right of bank-note issue, such as have been adverted to in a note on a preceding page, the views of the English currency school obtained an acceptance among professional economists and writers on finance even wider and more complete than in England, although in but few states did this lead to legislation in any degree comparable, in scope or stringency of operation, to the English act of 1844. The leading writers on this question in the United States, were Messrs. William M. Gouge, Condy Raguet and Amasa Walker.

226. The Currency Principle vs. the Banking Principle. —The question whether a body of money composed partly of coin and partly of bank notes fully convertible into coin, acts in all respects as would a body of money composed wholly of coin, or, on the other hand, has the capability of being issued in local excess and so maintained for a long enough time to affect local prices, and thus initiate abnormal movements of

* The principal features of the act of 1844, as affecting the circulation, are as follows: 1st. The Bank of England is allowed to issue notes, in a constant sum of £15,000,000, without any specie basis. For all notes above this, it must have, pound for pound, a specie reserve, of which one-fifth may be silver. [This last in consideration of the commercial and political relations of England with India, which has silver money.]

2nd. The issue department and the banking department of the Bank are completely divorced, becoming as separate as the Customs and the Internal Revenue bureaus of our own government.

3rd. No London bank can issue notes, nor can any bank chartered since 1844; while the issues of the English banks then existing are limited to their ordinary outstanding circulation prior to that date.

trade and production, I regard as the one open question in the theory of money. Brought up in the school which held the latter view, my own reading and reflection have confirmed me in the belief that there resides in bank money, even under the most stringent provisions for convertibility, the capability of local and temporary inflation. The arguments on the two sides of the question are so evenly balanced, and the statistical evidence is so ambiguous, that differences of opinion are likely long to exist between men of intelligence and candor. I freely confess that the preponderance of authoritative opinion is against the view I hold.

CHAPTER VII.

THE REACTION OF EXCHANGE UPON PRODUCTION.

227. Evil Possibilities involved in the Division of Labor. —We have seen that the division of labor is an essential condition of large and varied production. But the division of labor, when carried far, involves possibilities of loss and disaster. These become more and more serious as production becomes more and more extended and complicated, until, in the most highly organized industrial state, we have to explain the failure of a community to realize its full productive capability, mainly by reference to industrial misadventures and even, at times, a partial paralysis of the productive powers of the community, originating in this very source.

The cause of the trouble adverted to is found in misunderstandings between producers and consumers, whom it is the nature of the division of labor to set apart, and, in an advanced industrial state, widely apart, often by half the circumference of the globe.

It is evident that, were there no division of labor into separate occupations, the relation between production and consumption would be a simple one. Production would, within the capabilities of the several agents concerned, *viz.,*