the example of many of the greatest deposit banks of the world. "Issuing," says Mr. Nicholson, "is creating money; banking is managing money after it has been issued."

"A bank of issue," says Lord Overstone, "is intrusted with the creation of the circulating medium; a bank of deposit and discount is concerned only with the use, distribution or application of that circulating medium. The principles upon which these two branches of business ought to be conducted are perfectly distinct, and never can be reduced to one and the same rule."

The great London joint-stock banks, a single one of which holds deposits rising into tens of millions, and whose ordinary dividends are three times as great as those of the Bank of England, never issue a note.

In this country, however, the word bank, through much of our history, has to most people signified little more than a place where paper money was manufactured.

529. The Banking Agencies.—Such are the banking functions. The agencies by which the functions are performed may be grouped under four heads: (1), state banks; (2), joint-stock banks; (3), private banks; (4), bill-brokers and dealers in exchange. These agents enter in very different proportions to effect the banking work to be done in different countries. In this country, so large a part of the banking work was, from the beginning of the country till the outbreak of the war of secession, done by joint-stock banks, that it may be broadly said that this was the sole banking agency known to our people, although, in a few cities, private banking houses of high reputation were early started and well maintained, and the business of bill-broking was not unrecognized. Under another title, we shall give a brief sketch of the present "National Banking System" of the United States.

XII.

THE PRESENT BANKING SYSTEM OF THE UNITED STATES.

530.—The National Banking System of the U. S.*—No bank, in the modern sense of that term, was established in America during the colonial period. The word, bank, was indeed sometimes used, with reference, however, to a batch of paper money issued from a colonial treasury. During the revolution the eminent financier, Robert Morris, established a bank in aid of the continental finances. In 1790 there were three banks in the United States; the Bank of North America, in Philadelphia, established, as related, by Robert Morris, but then under a charter from the state of Pennsylvania; the Bank of New York, in the city of that name; and the Bank of Massachusetts, in Boston. In 1791 was created the first Bank of the United States, with a capital of ten millions of dollars, having a charter for twenty years, with power to issue notes payable on demand in specie. So completely without regulation and without inspection was the so-called paper money of the United States in that period, that it is impossible to recover the facts of banking capital, circulation, deposits or specie. Scarcely a statistical fragment survives. There is reason to suppose that the officers of many banks did not themselves know the liabilities of their own institutions. The paper money issued by such an institution, was, in every economic sense, inconvertible. The pretense of conversion could only be maintained by a stringent public opinion, hostile to the presentation of bank notes for redemption, by bank retaliations, and even, in frontier communities, by "lynch law."

531. On the refusal of Congress to re-charter the bank of the United States, a large number of the state banks sprang into existence, almost all of the usual American "joint-stock" type, on the principle of limited liability. In not a single state were the banks subject to regulation or even supervision,

* The first part of this article is condensed from the twelfth chapter of my work on Money, Trade and Industry.

to make sure that they did their duty or that they did not commit injury. The language of Mr. J. R. McCulloch, regarding the American banking system of that day, is hardly extravagant. "Had a committee of clever men been selected to devise means by which the public might be tempted to engage in all manner of absurd projects, and be most easily duped and swindled, we do not know that they could have hit upon any thing half so likely to effect their object as the existing American banking system. It has no redeeming quality about it, but is, from beginning to end, a compound of quackery and imposture."

532. The outbreak of war with England caused the suspension of specie payments by nearly all banks except those of New England; but this was followed by an enormous increase of issues, so that the outstanding notes, which had been estimated at twenty millions in 1811, rose, according to Secretary Crawford, to somewhere between sixty-two and seventy millions in 1813, and to somewhere between ninety-nine and a hundred and ten millions in 1815. The fact that it was impossible for the secretary of the treasury to tell, within eleven millions, the amount of the notes outstanding, is fairly characteristic of the monetary system at this time. The circulating paper was of every degree of value down to utter worthlessness. Many banks were ably managed by honest men, with reasonable regard to the public interest. Many were organized and conducted by sharpers and swindlers, as a means of wholesale robbery.*

At the close of the war, in 1815, the depreciation of bank paper reached, in some cases, fifteen, twenty and even twenty-five per cent. The excess of circulating paper had also been promoted by the extensive issue of United States treasury

* Prof. Sumner, in his History of American Currency, states that the Farmers' Exchange bank, of Gloucester, Mass., was organized with a nominal capital of one million dollars. Only $19,141.46 was ever paid in; and of this the directors subsequently withdrew their own subscriptions, leaving $3,081.11. One man bought out eleven directors for $1,300 each and then loaned himself $760,265. When the bank failed it had $86.46 in specie. The bank notes outstanding were estimated at $580,000

notes. These were not of forced circulation; they failed to be paid at maturity, and added greatly to commercial distrust and distress. Throughout 1816 the banks continued to issue their discredited notes, while floods of unchartered scrip were poured out, in bills of all denominations from six cents upward.

533. The evils of the financial situation led to the establishment, in 1816, of the second Bank of the United States, with a capital of thirty-five millions, of which the United States government owned one-fifth, and with a charter having twenty years to run. Before 1836, however, the bank had been broken down by the relentless attacks of President Jackson, and it was finally driven to take refuge under a Pennsylvania charter. Our space will not serve to discuss how far the failure of the second United States Bank to perform its anticipated office of regulating the paper circulation and of preventing excessive and improper issues by the state banks, was due to its original constitution; how far to false management; how far to circumstances; how far to persecution by the administration. Suffice it to say that the paper money of the country, during this period, was a weltering chaos. The wildly extravagant issues of really inconvertible paper money, supplied the motive and the means for every species of extravagant, wanton and irresponsible speculation. Words could scarcely exaggerate the extent to which the distortion of production and the misapplication of capital were carried.* The whole head was sick and the whole heart faint.

* "That the evils of this period were due chiefly to vices of paper money banking seems too clear to be questioned. The opening up of the western country would inevitably have led to much wild adventure, commercially and industrially; but it was the 'elasticity' of the circulation, the facility of local issue, without the reality, or scarcely the pretense, of redemption, which made the banks, even the best of them, reckless as to the character of the enterprises to which they gave assistance; while the money thus put into circulation, without 'reflux,' enhanced prices, and still further stimulated both speculative investments and speculative trading. When the courage of the better class of banks gave way, hundreds of 'wild cat' or 'coon-box banks,' so called, without capital,

The retribution came in the panic of 1837, in the second and heavier shock of 1839, and in the long and dreary prostration of industry which followed.

534. The experiences of this period led, in several states, to legislation designed to place the issue of bank notes on a sounder basis. In 1838 the free banking system of New York was established, under which all circulating notes were to be secured by deposit, with the state comptroller, of United States or New York stocks or bonds, and of mortgages on improved or productive real estate. A little later a law was passed requiring each bank to redeem its notes at some agency in New York city, Albany or Troy. Subsequent acts increased the proportion of securities to notes issued, and furnished further guaranties to holders.

This is the scheme of secured circulation, known as the New York system, which came to be imitated, more or less fully; and on which, to a considerable extent, the banking laws of the United States are framed.

The plan of basing a circulation upon securities is not to be altogether approved. It does not give convertibility, in the sense of preventing excessive issues, even in the view of the advocates of the "banking principle." * It does not so much as secure the perfect acceptability of the notes, as a medium of exchange, since the receiver desires to be assured that the notes will, at any moment, be worth what he has taken them for, whereas the New York system only gives him a pledge that, should the bank fail to redeem its notes, he will, at some future date, after the bank shall have been wound up and the securities disposed of by the comptroller, receive the face value of all the notes which he may then hold.

without a constituency, with no past and no expectations of a future, whose managers risked nothing and had nothing to lose, came forward with loans of notes to speculators who planned to build cities in the wilderness, or contractors who proposed to construct roads and bridges without materials, tools, or money to pay wages. Again, as in early New England, a bank meant a batch of paper money."—Walker: Money, Trade and Industry.

* See paragraphs 224–6.

535. But while this system can not be accepted as based upon perfectly sound principles of money, or even of banking policy, it proved at the time so great a check on reckless paper money banking, and it has had so great an effect in educating the public mind to more correct views of the banking function and of the responsibilities attaching to note issues, that it deserves to be treated with much consideration by the historian of American money. The painful experiences of 1837–40, and the active discussion of the principles of money and banking which they called forth; the growth of a public sentiment condemning an excess of paper issues, and the formulation of precepts, more or less carefully observed by bank managers; a vast improvement in the commercial morality of the country, due partly to education, and even more to the development of manufactures which, to a vastly greater degree than agriculture, rest on good faith and commercial honesty; the shortening of the terms of credit;* these causes, together with the legislation which has been described and the development of the Suffolk bank system † in New England, served to place the paper money issues of the United States on an improved basis between 1840 and 1860. The rapid improvement of trade and industry after the panic of 1857, already alluded to (par. 243), affords a striking proof of the comparative soundness of credit, trade and industry in the later period.

536. Early in the war of secession, the treasury being in great distress, Secretary Chase initiated the movement which resulted in the establishment of the present banking system of the United States. This system was to be essentially modeled on that established in New York by the law of 1838, all note issues being secured by an abundant deposit, at

* Prior to 1837 commercial credits were often extended to twelve and even eighteen months.

† This was a system, gradually developed, by which substantially all the banks of New England were brought to maintain a deposit with the Suffolk Bank of Boston, in consideration of which that bank bound itself to redeem their notes on presentation.

the Treasury Department in Washington, of United States stocks. Indeed, it was this feature which furnished the real motive to the scheme. The Treasury was to sell to the banks some hundreds of millions of bonds, as the basis for their note circulation, while all notes of state banks not coming under the new system were to be "taxed out of circulation."

As a measure of fiscal resource, the national bank law was essentially a failure. Owing to the delay in securing the desired legislation * and in transmuting the existing state banks into national banks, it was not until the war was nearly over and until the credit of the United States had become so well established as to give the Treasury the ability to borrow freely, at home or abroad, that the new national banks began to call for bonds in large amounts, as a basis of circulation.

537. But while that banking system failed to answer the expectations of Secretary Chase as a fiscal resource, it resulted in placing the paper money banking of the country on a more secure and convenient basis than it had ever before occupied. In all previous periods of our national history the bank money of some sections had been liable to a discount—often a considerable discount—if offered far away from the place of issue; while, in addition to the actual losses sustained by holders, the annoyance resulting from the frequent refusal to receive banknotes by those who did not know about the individual bank whose name and devices they bore, was almost intolerable. Under the existing system, a national banknote from Texas or Minnesota, if not suspected to be counterfeit, passes as readily in Massachussetts or Pennsylvania as the notes of local banks. By the new law, the United States Comptroller of the Currency, whose office was then created, was authorized to permit the establishment, for a term not exceeding twenty years, of banking associations consisting of not less than five persons, with a minimum capital, except in small places, of one hundred thousand dollars. Such associations were required

* The act establishing the national banking system bears date February, 1863.

to deposit, with the Treasury Department, United States bonds to the extent of at least one-third their capital, for which there should be issued to them circulating notes in amount equal to ninety per cent. of the market value of their bonds, but not beyond ninety per cent. of the par value of such bonds. The issue of currency, under this act, was to be limited to three hundred millions, that amount to be apportioned among the States according to population and banking capital.

In 1882, a new law was passed, providing for extending the charters of national banks.

538. The operation of the law regarding the deposit of United States bonds as a basis of circulation, may be illustrated as follows: A national bank expends $160,000 in the purchase of bonds, then selling at 80 per cent. of their par or face value. The bank would then hold bonds to the amount (at par) of $200,000. On the deposit of these, the treasury department would issue circulating notes thereon to the extent of ninety per cent., not of their par, but of their market value, viz.: one hundred and forty-four thousand dollars. These notes, bearing its own corporate title and its characteristic devices, the bank would issue in the discount of commercial paper. This might, in fact, constitute the greater part of what the bank had, at the outset, to loan—its own promises to pay. If we suppose the bank to keep out the whole body of notes received from the treasury on loans bearing interest at an average rate of five per cent., the annual income from this source will be $7,200. In addition thereto, the bank will receive from the treasury department, semi-annually or quarterly, drafts for the amount of the interest falling due on the bonds held for the redemption of the notes. If the rate of interest on the bonds were four per cent. (on the par value, of course), the amount so received would be $8,000 a year, making the aggregate income on both accounts, $15,200. This would be a return of 9½ per cent. on the amount—$160,000—expended in the purchase of the bonds. In addition thereto, would be the expectation of profit arising from the fact that, at the maturity of the bonds, be that five, fifteen, thirty or fifty years hence, the government is bound to pay the face value of the bonds, whereas the bank purchased them at eighty per cent. Now, the "present value" of twenty (100-80) dollars, at five per cent. interest, is considerable if payable in five years, is worth considering if payable in fifteen years, is inconsiderable if payable in thirty or fifty years: so that this element may amount to much, little or nothing, according to the term which the bonds have to run.

If, in a second case, the bank invested the same sum—$160,000, in United States bonds, at par, it would receive bonds to the amount of $160,000, on which the treasury department would issue $144,000 worth of circulating notes, as before, being ninety per cent., this time, alike of the market and of the par value of the bonds held for redemption. Making the same assumptions as before, regarding the average rate of interest realized by the bank on its loans, and the rate of interest on the bonds themselves, we should have the income from the former source, $7,200, and from the latter source, $6,400; an aggregate of $13,600, being eight and a half per cent. on the amount invested, with no longer any expectation of profit from the difference between the amount of purchase money and the principal of the bonds to be paid at maturity.

If, in a third case, we suppose that the bank expends the same amount, as before, in the purchase of United States bonds, bearing a premium of twenty-five per cent. (and the bonds of the United States have almost always been at a premium, greater or less, at times rising, on some classes of bonds, to the rate assumed), the face value of the bonds so purchased would be but $128,000, on which the treasury department would issue notes to the amount of $115,200, being ninety per cent. of the face value of the bonds, though but seventy-two per cent., this time, of their market value. On the same assumption as to interest, etc., as before, the bank would receive from the loan of its notes $5,760; from the government, as interest on the bonds, $5,120; an aggregate of $10,880, or only six and eight-tenths per cent. on the $160,000 invested. In this case, moreover, there must be taken into account an ultimate loss of one-fifth of the purchase money. Although the bank has paid $125 for each $100 bond, the government will, at maturity, pay only the face value, namely, $100. The "present value" of the amount thus to be, sooner or later, lost, is to be determined by the same principles which would be applied to obtaining the "present value" of the amount to be ultimately gained, had the bank purchased bonds at a discount. As we said before, their "present value" would be much, little or practically nothing, according to the term which the bonds had to run.

539. The profit to the banks, under the present system, largely depends, it will be seen, upon two elements: the rate of interest on the bonds themselves, and the premium or discount at which the bonds can be, at any given time, purchased. During the war, a bank could purchase, for $100,000 in greenbacks, an equal amount of six per cent. bonds, payable, principal and interest, in gold. Depositing these in the treasury, it would receive $90,000 in circulating notes, which it would loan at such rates of interest as the commercial demands of the time allowed, and would receive each year, as interest, $6,000 in gold, which it could sell at twenty-five, fifty or even a hundred per cent. advance in greenbacks, according to the enormously high, though fluctuating, war premiums on gold then prevailing. The gradual decline and finally the disappearance of the premium on gold*; the reduction in the rate of interest on government bonds from six per cent. to five, to four and a half, and ultimately to three and a half and even three per cent., through successive refunding operations; and lastly the appearance of high premiums upon bonds bearing the reduced rates of interest, these three causes have concurred to diminish, point by point, the profit, to the bank, in buying United States bonds and depositing them with the treasury department, as the basis of note circulation, until, at the present time (1887), many banks are surrendering their circulation, finding it more to their interest to use the capital at their command in other ways. The number of

* Specie payments were resumed on January 1, 1879.

national banks at the present time in existence, is about two thousand nine hundred. These are, of course, distributed very irregularly over the surface of the country.

540. The money of the United States now consists of gold coin (twenty, ten, five, two and a half or one dollar pieces), legal tender for debts in any amount; (2) of silver dollars, legal tender in any amount; (3) of subsidiary silver coins (fifty, twenty-five, twenty, ten or five cent. pieces), legal tender in small amounts as change; (4) of copper or nickel coins (five, three, two or one cent pieces); (5) of "greenbacks," of various denominations, from one dollar to one thousand dollars; (6) of "gold notes" and (7) of "silver notes," of various denominations, issued solely upon the deposit, at the several sub-treasuries,* of equivalent amounts of gold or silver; (8) of national banknotes, issued as hereinbefore described. In this highly complex mass, the proportion of banknotes is continually diminishing, owing to the reduction in the profits of banknote circulation already accounted for. This fact constitutes one of the gravest features of the financial situation, and threatens the country with the speedy loss of all the advantages thus far enjoyed under the national banking system.

XIII.

FOREIGN EXCHANGES.

541. Meaning of Exchange.—Formerly, when debts were paid by the merchants of one country to those of another, it was almost always necessary actually to change the money of the debtor country into that of the creditor country. Thus, if a merchant in Paris had occasion to pay a debt to a mer-

* After the destruction of the second United States Bank and the crisis of 1837-9, the United States government adopted the policy of keeping its funds in its own treasury at Washington, or in the custody of "assistant treasurers," appointed in the great commercial cities. The offices of the assistant treasurers are popularly called "sub-treasuries." The origin and development of the sub-treasury system will afford an admirable economic exercise for advanced students.

chant in Antwerp, it was necessary first to compute the quantity of "*fine*" (*i. e.* pure) silver contained in the amount of Antwerp money due under the contract; then to find out how many French coins (their weight and fineness being known) would be required to make up that amount of pure silver. This being ascertained, the Paris merchant paid down the French money (*plus* the premium, or *minus* the discount, of which we shall speak later) and received the Paris banker's order upon some Antwerp banker to pay the Antwerp merchant the amount of Antwerp money due him. It was with reference to this changing of one kind of money into another, that the term exchange was first applied to this class of transactions. It came in time, however, to be equally applied to transactions between cities under the same government, having the same kinds of money, where, hence, no actual changing of money pieces was required.

At the present time, this changing of money pieces plays a very much less important part in exchange. Instead of many states having independent authority to coin money, there is now but one coining authority in all Italy. The money of Germany is now uniform in weight and fineness. France, Italy, Belgium, Switzerland, Greece and Austria have certain money coins which may be said to be in common, *i. e.*, they contain the same amount of pure metal, though under different denominations and with different inscriptions. The vast extension of the British empire has made the "sovereign" current money over a large part of the globe.

542. What is Exchange?—In essence, where a man *buys exchange*—he buys the right to have paid to him, or his agent, or his creditor, a certain amount of fine gold or silver, to be delivered in some other place mentioned in the contract. If I buy in New York "exchange on London," some one who has gold in London, or who has a right to demand gold there, sells me his claim to receive a definite amount of that metal, in London, at a definite time, or at my convenience if we so agree. I may then, either go to London and get the metal, as, for instance, if I am starting out on a European tour, or I may send an order, by post or telegraph, for some one else to get