Chapter IX.

Influence Of Credit On Prices.

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§ 1. What acts on prices is Credit, in whatever shape given.

Having now formed a general idea of the modes in which credit is made available as a substitute for money, we have to consider in what manner the use of these substitutes affects the value of money, or, what is equivalent, the prices of commodities. It is hardly necessary to say that the permanent value of money--the natural and average prices of commodities--are not in question here. These are determined by the cost of producing or of obtaining the precious metals. An ounce of gold or silver will in the long run exchange for as much of every other commodity as can be produced or imported at the same cost with itself. And an order, or note of hand, or bill payable at sight, for an ounce of gold, while the credit of the giver is unimpaired, is worth neither more nor less than the gold itself.

It is not, however, with ultimate or average, but with immediate and temporary prices that we are now concerned. These, as we have seen, may deviate very widely from the standard of cost of production. Among other causes of fluctuation, one we have found to be the quantity of money in circulation. Other things being the same, an increase of the money in circulation raises prices; a diminution lowers them. If more money is thrown into circulation than the quantity which can circulate at a value conformable to its cost of production, the value of money, so long as the excess lasts, will remain below the standard of cost of production, and general prices will be sustained above the natural rate.

But we have now found that there are other things, such as bank-notes, bills of exchange, and checks, which circulate as money, and perform all the functions of it, and the question arises, Do these various substitutes operate on prices in the same manner as money itself? I apprehend that bank-notes, bills, or checks, as such, do not act on prices at all. What does act on prices is Credit, in whatever shape given, and whether it gives rise to any transferable instruments capable of passing into circulation or not.

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§ 2. Credit a purchasing Power, similar to Money.

Money acts upon prices in no other way than by being tendered in exchange for commodities. The demand which influences the prices of commodities consists of the money offered for them. Money not in circulation has no effect on prices.

In the case, however, of payment by checks, the purchases are, at any rate, made, though not with the money in the buyer's possession, yet with money to which he has a right. But he may make purchases with money which he only expects to have, or even only pretends to expect. He may obtain goods in return for his acceptances payable at a future time, or on his note of hand, or on a simple book-credit--that is, on a mere promise to pay. All these purchases have exactly the same effect on price as if they were made with ready money. The amount of purchasing power which a person can exercise is composed of all the money in his possession or due to him, and of all his credit. For exercising the whole of this power he finds a sufficient motive only under peculiar circumstances, but he always possesses it; and the portion of it which he at any time does exercise is the measure of the effect which he produces on price.

Suppose that, in the expectation that some commodity will rise in price, he determines not only to invest in it all his ready money, but to take up on credit, from the producers or importers, as much of it as their opinion of his resources will enable him to obtain. Every one must see that by thus acting he produces a greater effect on price than if he limited his purchases to the money he has actually in hand. He creates a demand for the article to the full amount of his money and credit taken together, and raises the price proportionally to both. And this effect is produced, though none of the written instruments called substitutes for currency may be called into existence; though the transaction may give rise to no bill of exchange, nor to the issue of a single bank-note.

The buyer, instead of taking a mere book-credit, might have given a bill for the amount, or might have paid for the goods with bank-notes borrowed for that purpose from a banker, thus making the purchase not on his own credit with the seller, but on the banker's credit with the seller, and his own with the banker. Had he done so, he would have produced as great an effect on price as by a simple purchase to the same amount on a book-credit, but no greater effect. The credit itself, not the form and mode in which it is given, is the operating cause.

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§ 3. Great extensions and contractions of Credit. Phenomena of a commercial crisis analyzed.

The inclination of the mercantile public to increase their demand for commodities by making use of all or much of their credit as a purchasing power depends on their expectation of profit. When there is a general impression that the price of some commodity is likely to rise from an extra demand, a short crop, obstructions to importation, or any other cause, there is a disposition among dealers to increase their stocks in order to profit by the expected rise. This disposition tends in itself to produce the effect which it looks forward to--a rise of price; and, if the rise is considerable and progressive, other speculators are attracted, who, so long as the price has not begun to fall, are willing to believe that it will continue rising. These, by further purchases, produce a further advance, and thus a rise of price, for which there were originally some rational grounds, is often heightened by merely speculative purchases, until it greatly exceeds what the original grounds will justify. After a time this begins to be perceived, the price ceases to rise, and the holders, thinking it time to realize their gains, are anxious to sell. Then the price begins to decline, the holders rush into the market to avoid a still greater loss, and, few being willing to buy in a falling market, the price falls much more suddenly than it rose. Those who have bought at a higher price than reasonable calculation justified, and who have been overtaken by the revulsion before they had realized, are losers in proportion to the greatness of the fall and to the quantity of the commodity which they hold, or have bound themselves to pay for.

This is the ideal extreme case of what is called a commercial crisis. There is said to be a commercial crisis when a great number of merchants and traders at once either have, or apprehend that they shall have, a difficulty in meeting their engagements. The most usual cause of this general embarrassment is the recoil of prices after they have been raised by a spirit of speculation, intense in degree, and extending to many commodities. When, after such a rise, the reaction comes and prices begin to fall, though at first perhaps only through the desire of the holders to realize, speculative purchases cease; but, were this all, prices would only fall to the level from which they rose, or to that which is justified by the state of the consumption and of the supply. They fall, however, much lower; for as, when prices were rising, and everybody apparently making a fortune, it was easy to obtain almost any amount of credit, so now, when everybody seems to be losing, and many fail entirely, it is with difficulty that firms of known solidity can obtain even the credit to which they are accustomed, and which it is the greatest inconvenience to them to be without, because all dealers have engagements to fulfill, and, nobody feeling sure that the portion of his means which he has intrusted to others will be available in time, no one likes to part with ready money, or to postpone his claim to it. To these rational considerations there is superadded, in extreme cases, a panic as unreasoning as the previous over-confidence; money is borrowed for short periods at almost any rate of interest, and sales of goods for immediate payment are made at almost any sacrifice. Thus general prices, during a commercial revulsion, fall as much below the usual level as during the previous period of speculation they have risen above it; the fall, as well as the rise, originating not in anything affecting money, but in the state of credit.

Professor Jevons seriously advanced a theory that, inasmuch as the harvests of the world were the causes of good or bad trade, and that their deficiency would regularly be followed by commercial distress, then a periodic cause of bad harvests, if found, would explain the constant recurrence of commercial crises. This cause he claimed to have found in the sun-spots, which periodically deprive the crops of that source of growth which is usually furnished by the sun when no spots appear.(243) It has not received general acceptance.

In the United States financial disasters have occurred in 1814, 1819, 1825, 1837-1839, 1857, and 1873. Those of 1837 and 1873 seem to have been the most serious in their effects; but this field, so far as scientific study is concerned, has not been fully worked, and much remains to be learned about these crises in the United States. The crisis of 1873 was due to excessive railway-building. It was testified(244) concerning the New York banks in 1873 that "their capital needed for legitimate purposes was practically lent out on certain iron rails, railroad-ties, bridges, and rolling-stock, *called* railroads, many of them laid down in places where these materials were practically useless."

Under the effects due to swift communication by steam, but especially to the electric telegraph, modern credit is a very different thing from what it was fifty years ago. Now, a shock on the Bourse at Vienna is felt the same day at Paris, London, and New York. A commercial crisis in one great money-center is felt at every other point in the world which has business connections with it. Moreover, as Cherbuliez(245) says: "A country is more subject to crises the more advanced is its economical development. There are certain maladies which attack only grown-up persons who have reached a certain degree of vigor and maturity."

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§ 4. Influence of the different forms of Credit on Prices.

It does not, indeed, follow that credit *will* be more used because it *can* be. When the state of trade holds out no particular temptation to make large purchases on credit, dealers will use only a small portion of the credit-power, and it will depend only on convenience whether the portion which they use will be taken in one form or in another. One single exertion of the credit-power in the form of (1) book-credit, is only the foundation of a single purchase; but, if (2) a bill is drawn, that same portion of credit may serve for as many purchases as the number of times the bill changes hands; while (3) every bank-note issued renders the credit of the banker a purchasing power to that amount in the hands of all the successive holders, without impairing any power they may possess of effecting purchases on their own credit. Credit, in short, has exactly the same purchasing power with money; and as money tells upon prices not simply in proportion to its amount, but to its amount multiplied by the number of times it changes hands, so also does credit; and credit transferable from hand to hand is in that proportion more potent than credit which only performs one purchase.

There is a form of credit transactions (4) by checks on bankers, and transfers in a banker's books, which is exactly parallel in every respect to bank-notes, giving equal facilities to an extension of credit, and capable of acting on prices quite as powerfully. A bank, instead of lending its notes to a merchant or dealer, might open an account with him, and credit the account with the sum it had agreed to advance, on an understanding that he should not draw out that sum in any other mode than by drawing checks against it in favor of those to whom he had occasion to make payments. These checks might possibly even pass from hand to hand like bank-notes; more commonly, however, the receiver would pay them into the hands of his own banker, and when he wanted the money would draw a fresh check against it; and hence an objector may urge that as the original check would very soon be presented for payment, when it must be paid either in notes or in coin, notes or coin to an equal amount must be provided as the ultimate means of liquidation. It is not so, however. The person to whom the check is transferred may perhaps deal with the same banker, and the check may return to the very bank on which it was drawn.

This is very often the case in country districts; if so, no payment will be called for, but a simple transfer in the banker's books will settle the transaction. If the check is paid into a different bank, it will not be presented for payment, but liquidated by set-off against other checks; and, in a state of circumstances favorable to a general extension of banking credits, a banker who has granted more credit, and has therefore more checks drawn on him, will also have more checks on other bankers paid to him, and will only have to provide notes or cash for the payment of balances; for which purpose the ordinary reserve of prudent bankers, one third of their liabilities, will abundantly suffice.

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§ 5. On what the use of Credit depends.

The credit given to any one by those with whom he deals does not depend on the quantity of bank-notes or coin in circulation at the time, but on their opinion of his solvency. If any consideration of a more general character enters into their calculation, it is only in a time of pressure on the loan market, when they are not certain of being themselves able to obtain the credit on which they have been accustomed to rely; and even then, what they look to is the general state of the loan market, and not (preconceived theory apart) the amount of bank-notes. So far, as to the willingness to *give* credit. And the willingness of a dealer to *use* his credit depends on his expectations of gain, that is, on his opinion of the probable future price of his commodity; an opinion grounded either on the rise or fall already going on, or on his prospective judgment respecting the supply and the rate of consumption. When a dealer extends his purchases beyond his immediate means of payment, engaging to pay at a specified time, he does so in the expectation either that the transaction will have terminated favorably before that time arrives, or that he shall then be in possession of sufficient funds from the proceeds of his other transactions. The fulfillment of these expectations depends upon prices, but not specially upon the amount of bank-notes. It is obvious, however, that prices do not depend on money, but on purchases. Money left with a banker, and not drawn against, or drawn against for other purposes than buying commodities, has no effect on prices, any more than credit which is not used. Credit which *is* used to purchase commodities affects prices in the same manner as money. Money and credit are thus exactly on a par in their effect on prices.

It is often seen, in our large cities, that money is very plentiful, but no one seems to wish its use (that is, no one with safe securities). Inability to find investments and to find industries in which the rate of profit is satisfactory--all of which depends on the business character and activity of the people--will prevent credit from being used, no matter how many bank-notes, or greenbacks, or how much gold there is in the country. It is impossible to make people invest, simply by increasing the number of counters by which commodities are exchanged against each other; that is, by increasing the money. The reason why more credit is wanted is because men see that increased production is possible of a kind that will find other commodities ready to be offered (i.e., demand) in exchange for that production. Normal credit, therefore, on a healthy basis, increases and slackens with the activity or dullness of trade. Speculation, or the wild extension of credit, on the other hand, is apt to be begotten by a plethora of money, which has induced low rates for loans, and moves with the uncertain waves of popular impression. By normal credit we mean that the wealth represented by the credit is really at the disposal of the borrowers; in a crisis, the quantity of wealth supposed to be represented by credit is very much greater than that at the disposal of the lenders.(246)

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§ 6. What is essential to the idea of Money?

There has been a great amount of discussion and argument on the question whether several of these forms of credit, and in particular whether bank-notes, ought to be considered as money. It seems to be an essential part of the idea of money that it be legal tender. An inconvertible paper which is legal tender is universally admitted to be money; in the French language the phrase *papier-monnaie* actually *means* inconvertibility, convertible notes being merely *billets à porteur*. An instrument which would be deprived of all value by the insolvency of a corporation can not be money in any sense in which money is opposed to credit. It either is not money, or it is money and credit too.

It would seem, from all study of the essentials of money (Book III, Chapter IV), that the necessary part of the idea of money is that it should have value in itself. No one parts with valuable commodities for a medium of exchange which does not possess value; and we have seen that Legislatures can not control the natural value of even the precious metals by giving them legal-tender power. Much less could it be done for paper money. Paper, therefore, may, as an instrument of credit, be a substitute for money; but, in accordance with the above test, it can not properly be considered as money in the full sense. Of course, paper money, checks, etc., perform some of the functions of money equally well with the precious metals. F. A. Walker holds that anything is money which performs money-work; but he excludes checks from his catalogue of things which may serve as money. It is practically of little importance, however, what we include under money, so long as its functions are well understood; it is merely a question of nomenclature, and need not disturb us.