

## CHAPTER XII

# Influence of Credit on Prices

§ 1. [*The influence of bank notes, bills, and cheques, on price is a part of the influence of Credit*] 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 cheques, 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? Does an increase in the quantity of transferable paper tend to raise prices, in the same manner and degree as an increase in the quantity of money? There has been no small amount of discussion on this point among writers on currency, without any result so conclusive as to have yet obtained general assent.

I apprehend that bank notes, bills, or cheques, 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.

I proceed to explain and substantiate this opinion.

§ 2. [*Credit is 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. But the money offered, is not the same thing with the money possessed. It is sometimes less, sometimes very much more. In the long run indeed, the money which people lay out will be neither more nor less than the money which they have to lay out: but this is far from being the case at any given time. Sometimes they keep money by them for fear of an emergency, or in expectation of a more advantageous opportunity for expending it. In that case the money is said not to be in circulation: in plainer language, it is not offered, nor about to be offered, for commodities. Money not in circulation has no effect on prices. The converse, however, is a much commoner case; people make purchases with money not in their possession. An article, for instance, which is paid for by a cheque on a banker, is bought with money which not only is not in the payer's possession, but generally not even in the banker's, having been lent by him (all but the usual reserve) to other persons. We just now made the imaginary supposition that all persons dealt with a bank, and all with the same bank, payments being universally made by cheques. In this ideal case, there would be no money anywhere except in the hands of the banker: who might then safely part with all of it, by selling it as bullion, or lending it, to be sent out of the country in exchange for goods or foreign securities. But though there would then be no money in possession, or ultimately perhaps even in existence, money would be offered, and commodities bought with it, just as at present. People would continue to reckon their incomes and their capitals in money, and to make their usual purchases with orders for the receipt of a thing which would have literally ceased to exist. There would be in all this nothing to complain of, so long as the money, in disappearing, left <sup>a</sup> an equivalent value in other things, applicable when required to the reimbursement of those to whom the money originally belonged.

In the case however of payment by cheques, the purchases are at any rate made, though not with 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

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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.

§ 3. [*Effects of 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 <sup>a</sup> 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.

Now all these effects might take place in a community to which credit was unknown: the prices of some commodities might rise from speculation, to an extravagant height, and then fall rapidly back. But if there were no such thing as credit, this could hardly happen with respect to commodities generally. If all purchases were made with ready money, the payment of increased prices for some articles would draw an unusual proportion of the money of the community into the markets for those articles, and must therefore draw it away from some other class of commodities, and thus lower their prices. The vacuum might, it is true, be partly filled up by increased rapidity of circulation; and in <sup>b</sup>this manner<sup>b</sup> the money of the community <sup>c</sup>is<sup>c</sup> virtually increased in a time of speculative activity, because people keep little of it by them, but hasten to lay it out in some tempting adventure as soon as possible after they receive it. This resource, however, is limited: on the whole, people cannot, while the quantity of money remains the same, lay out much more of it in some things, without laying out less in others. But what they cannot do by ready money, they can do by an extension of credit. When people go into the market and purchase with money which they hope to receive hereafter, they are drawing upon an unlimited, not a limited fund. Speculation, thus supported, may be going on in any number of commodities, without disturbing the regular course of business in others. It might even be going on in all commodities at once. We could imagine that in an epidemic fit of the passion of gambling, all dealers, instead of giving only their accustomed orders to the manufacturers or growers of their commodity, commenced buying up all of it which they could procure, as far as their capital and credit would go. All prices would rise enormously, even if there <sup>d</sup>were<sup>d</sup> no increase of money, and no paper credit, but a mere extension of purchases on book credits. After a time those who had bought would wish to sell, and prices would collapse.

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

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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. Some accident which excites expectations of rising prices, such as the opening of a new foreign market, or simultaneous indications of a short supply of several great articles of commerce, sets speculation at work in several leading departments at once. The prices rise, and the holders realize, or appear to have the power of realizing, great gains. In certain states of the public mind, such examples of rapid increase of fortune call forth numerous imitators, and speculation not only goes much beyond what is justified by the original grounds for expecting rise of price, but extends itself to articles in which there never was any such ground: these, however, rise like the rest as soon as speculation sets in. At periods of this kind, a great extension of credit takes place. Not only do all whom the contagion reaches, employ their credit much more freely than usual; but they really have more credit, because they seem to be making unusual gains, and because a generally reckless and adventurous feeling prevails, which disposes people to give as well as take credit more largely than at other times, and give it to persons not entitled to it. In this manner, in the celebrated speculative year 1825, and at various other periods during the present century, the prices of many of the principal articles of commerce rose greatly, without any fall in others, so that general prices might, without incorrectness, be said to have risen. 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 fulfil, and nobody feeling sure that the portion of his means which he has entrusted 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 overconfidence; 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; an unusually extended employment of credit during the earlier period, followed by a great diminution, never amounting however to an entire cessation of it, in the later.

It is not, however, universally true that the contraction of credit, characteristic of a commercial crisis, must have been preceded by an extraordinary and irrational extension of it. There are other causes; and 'one of the more' recent 'crises', that of 1847, is an instance, having been preceded by no particular extension of credit, and by no speculations; except those in railway shares, which, though in many cases extravagant enough, yet being carried on mostly with that portion of means which the speculators could afford to lose, were not calculated to produce the widespread ruin which arises from vicissitudes of price in the commodities in which men habitually deal, and in which the bulk of their capital is invested. The crisis of 1847 belonged to another class of mercantile phenomena. There occasionally happens a concurrence of circumstances tending to withdraw from the loan market a considerable portion of the capital which usually supplies it. These circumstances, in the present case, were great foreign payments, (occasioned by <sup>h</sup>a<sup>h</sup> high price of cotton and 'an' unprecedented importation of food,) together with the continual demands on the circulating capital of the country by railway calls and the loan transactions of railway companies, for the purpose of being converted into fixed capital and made unavailable for future lending. These various demands fell principally, as such demands always do, on the loan market. A great, though not the greatest part of the imported food, was actually paid for by the proceeds of a government loan. The extra payments which purchasers of corn and cotton, and railway shareholders, found themselves obliged to make, were either made with their own spare cash, or with money raised for the occasion. On the first supposition, they were made by withdrawing deposits from bankers, and thus cutting off a part of the streams which fed the loan market; on the second supposition, they were made by actual drafts on the loan market, either by the sale of securities, or by taking up money at interest. This combination of a fresh demand for loans, with a curtailment of the capital disposable for them, raised the rate of interest, and made it impossible to borrow except on the very best security. Some firms, therefore, which by an improvident and unmercantile mode of conducting business had allowed their capital to become either temporarily or permanently unavailable, became unable

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to command that perpetual renewal of credit which had previously enabled them to struggle on. These firms stopped payment: their failure involved more or less deeply many other firms which had trusted them; and, as usual in such cases, the general distrust, commonly called a panic, began to set in, and might have produced a destruction of credit equal to that of 1825, had not circumstances which may almost be called accidental, given to a very simple measure of the government '(the suspension of the Bank Charter Act of 1844)' a fortunate power of allaying panic, to which, when considered in itself, it had no sort of claim.\*

§ 4. [*Bills are a more powerful instrument for acting on prices than book credits, and bank notes than bills*] The general operation of credit upon prices being such as we have described, it is evident that if any particular mode or form of credit is calculated to have a greater operation on prices than others, it can only be by giving greater facility, or greater encouragement, to the multiplication of credit transactions generally. If bank notes, for instance, or bills, have a greater effect on prices than book credits, it is not by any difference in the transactions themselves, which are essentially the same, whether taking place in the one way or in the other: it must be that there are likely to be more of them. If credit is likely to be more extensively used as a purchasing power when bank notes or bills are the instruments used, than when the credit is given by mere entries in an account, to that extent and no more there is ground for ascribing to the former a greater power over the markets than belongs to the latter.

Now it appears that there is some such distinction. As far as respects the particular <sup>a</sup>transactions<sup>a</sup>, it makes no difference in the effect on price whether A buys goods of B on simple credit, or gives a bill for them, or pays for them with bank notes lent to him by a banker C. The difference is in a subsequent stage. If A has bought the goods on a book credit, there is no obvious or convenient mode by which B can make A's debt to him a means of extending his own credit. Whatever credit he has, will be due to the general opinion entertained of his solvency; he cannot specifically pledge A's debt to a third person, as a security for money lent or goods bought. But if A has given him a bill for the amount, he can get this discounted, which is the same thing as borrowing money on the joint credit

\*[65] The commercial difficulties, not however amounting to a commercial crisis, of 1864, had essentially the same origin. Heavy payments for cotton imported at high prices, and large investments in banking and other joint stock projects, combined with the loan operations of foreign governments, made such large drafts upon the loan market as to raise the rate of discount on mercantile bills as high as nine per cent.

<sup>f-f</sup>—52, 57, 62, 65, 71

<sup>a-a</sup>—48, 49, 52, 57, 62, 65 transaction