

IV.—*Banks of Issue in Germany.*—By Herr Hartwig S. Hertz of Hamburg.*

[Read 15th of June, 1857.]

JOINT STOCK BANKS authorized by government to issue paper money are of recent creation in Germany; but their establishment is now proceeding so rapidly, that it becomes a duty to investigate this subject with special reference to that experience already acquired in Great Britain and the United States which can be rendered serviceable to ourselves. It is desirable that we should first make clear the objects proposed by these new banks, and the means they have for realizing them.

The object of the banking system is twofold, to advance the public prosperity, and through this to advance the private fortunes of the projectors. It is apparent that these ends may both be realized, for the profits of the undertakers should be drawn from that fund which, arising out of those operations respecting the circulating medium in which the commerce of values consists, directly and indirectly contributes to the increase of the public wealth. The business of banking may consist only in a variety of functions which require neither the giving nor the asking of credit. A bank may also give credit, yet take none; but in so doing it must leave unused that power which might be derived from the credit due to its own capital. A bank which restricts its operations only to its paid up capital, differs as much in power from one that takes as well as gives credit, as does the water that drives a wheel from the same water when converted into steam. But in like manner with the one as with the other the increased power brings increased danger, which is so much the greater in the case of a bank, inasmuch as the force of credit thus created is used not by the bank alone but by others who avail themselves of it.

The new banks now daily springing up in Germany propose as their object both the giving and taking of credit, and the evil effects of their mismanagement would be felt not only by their immediate customers, but throughout all Germany. It is therefore of the greatest importance that this power of credit should be employed only for the furtherance of proper objects and within proper limits, and that the public should profit by the experience of Great Britain and America, and study the precautionary measures taken in those countries in order that they may form a sound judgment of the system pursued by the German banks respecting the issues of paper money.

The merchandize of the banker is the circulating medium, and this consists either of money, or of promises to pay money. Opinions no doubt differ on this head, there being some who consider that

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everything possessing value,—such as property real and personal, and even labour,—constitute a circulating medium; hence they infer that these may be used as instruments of exchange by being represented by bank notes. We are, however, of opinion that while, on the one hand, credit, in our present state of society, not only may but must be used as an instrument for effecting exchanges, and that, too, much oftener than money, on the other it is not everything which has exchangeable value that can truly represent or should be employed as a circulating medium.

But though *money* has a value in and for itself, the application of *credit* depends on the circumstances of society and personal character, and in addition to these we must take into account the usages and laws of the country where credit is given, and the facilities for enforcing payment of the debt, if necessary. The facilitating of credit is, however, the peculiar function of banking operations, when these are not confined merely to aiding actual payments in money. The banking capitalist either negotiates the granting of credit, or takes the risk of giving it upon himself. The security of the bank must depend on its good management, and the amount of collective and individual guarantee afforded by those who constitute its members, as well as on the laws which regulate the issue of paper money. Such regulations exist in England and in several States of North America, but in Germany as yet less foresight has been shown.

Hitherto we have spoken only of that species of credit which is employed by banks to give circulation to bills or other instruments of exchange subscribed by individuals, but not of that kind which is represented by the issuers of paper money. It is essential that the real meaning and value of these should be understood, and therefore we will next consider this form of credit.

The utility of a given amount of the circulating medium varies with its negociability, and the facility of passing it from hand to hand. This may be increased by a variety of causes, and especially by appropriate institutions, the effects and value of which are strikingly shown in the clearing-house system employed by the banks in London for effectuating their mutual payments. This facility depends, where credit is employed, greatly on the form of the promise to pay. Bills of exchange are much used in, and indeed are essential to great commercial operations, and so also are cheques. These are less used in Germany than in England or America, but it is probable that as our banking system extends, they will be more employed with us than at present.

These instruments are, however, in their practical import very different from bank notes, for the former palpably depend for their value on the solvency of the persons subscribing them, while the latter purport to be and in fact are commonly accepted as being equivalent to money and immediately convertible into it. Generally speaking, however, the security for this payment of notes does not rest on capital in money alone, but on other securities. In the case of most of the new German banks, the issue of notes the payment of which is guaranteed by pledges in real and personal property, is either not excluded or expressly contemplated. Experience has

shown that in ordinary times the effective convertibility of bank notes is sufficiently secured by making one-third of the guaranteeing fund consist of money, and this view has been generally adopted in the foundation of the new German banks. Bitter experience, however, both in Great Britain and in America, has proved that this rule alone will not afford adequate security against the abuse of paper money, and has caused the public to call for particular securities against this evil. Thus, in Great Britain since 1844, the bank of England is permitted to issue notes beyond the amount of gold in their coffers only so far as the state itself is answerable therefor through its own debt to the bank, and even that only to the extent of £14,000,000; and no bank established since that date can lawfully issue notes. Should we not learn from the experience of others?

It is evident that on the one hand the use of credit is indispensable, and on the other that no legal regulations or other dispositions can afford absolute security against deliberate fraud; this appears both from the experience of North America and that of England. Nor does unlimited liability of itself secure this end, though in Great Britain little disposition is shown to apply the principle of limited liability to banks, as has been done in the United States and now is in Germany. In 1793 numerous banks, both private and joint-stock, suspended payment, and the most eminent economists of the period agreed in attributing the bankruptcies which then followed in trade to the misplaced credit which in the antecedent years had been given and taken by the banks in furtherance of ill-judged speculations. The bank of England, however, which had not so acted, held its ground. A parliamentary committee of inquiry referred the origin of the evil to those banks which issued notes without sufficient capital, whence distrust spread to those which, if allowed time, could have cashed their notes. Hard times followed, and in the years from 1814 to 1816 eighty-nine, and in those of 1825 and 1826 eighty country banks became bankrupt; besides many others which compounded with their creditors. Similar bankruptcies occurred in later years, and before 1844, when the last reform of the banking system took place in England; though, as we have already said, no merely legislative measures can protect the public against the results of exaggerated speculation. In the autumn of 1846, while hazardous prospects were rife in trade, the bank of England had neglected to raise the rate of discount sufficiently. Amidst the ruin and confusion which ensued as the result of this over-speculation, the public confidence in the bank of England remained unshaken, and when the government on the 25th October, 1847, authorized it to issue notes beyond the prescribed proportion, keeping the discount, however, at 8 per cent., the issue thus allowed of the comparatively small amount of £400,000 in notes sufficed to restore confidence to the commercial world.

The author of the act of 1844 was obliged to confess that its regulations could afford no *absolute* security against such monetary crises; but, on the other hand, even its opponents admitted that after universal distrust had taken possession of the public mind, the provisions of the Bank Act of 1844 materially contributed to main-

tain confidence in the value of the notes of the bank of England, and that this feeling afforded the principal means of terminating the panic.

Instructive as is the history of banking in England during the last sixty years, that of the American system is still more valuable to us, as approaching in its circumstances nearer to our own. There, as with us, a variety of independent states exist, and in neither case is there any central bank of issue, the influence of which on the smaller banks, as is the case in England, imposes limits on the use of their credit. The bank of the United States was suppressed under the presidency of Jackson, as being at variance with republican institutions, and ceased to be the financial agent of the government. To this circumstance Sir Robert Peel ascribed the subsequent confusion of the banking system and circulating medium in the United States. As with us, so too in America the limited liability of bank shareholders is sanctioned. In Great Britain also there are many banks (including all founded since 1844) which issue no notes; but in America and Germany the reverse is the case.

So long as a bank note remains in circulation it fulfils all the functions of money, and the facility with which it passes from hand to hand tends to make the holders less careful in examining its real value as a *security* for the payment of money; notes, too, furnish a ready means of obtaining credit when realized capital is not forthcoming, and this is obviously a source of danger.

In a new country like America it would seem as if credit applied to productive labour could not be carried too far; experience shows, however, that such a system is ruinous when the circulating medium is based for the most part on confidence, for if this vanishes before the labour is terminated, or under circumstances when, though ended, its products bring less than their estimated or ordinary value, a crisis must ensue which will be more serious in proportion as the credit has been inconsiderately given. The notes being thus rendered worthless, the circulating medium is reduced in quantity; and prices falling, the real or personal property which may be held by the banks as a security for payment is rendered insufficient to meet their promises to pay.

Nevertheless, this erroneous principle of basing the issue of notes mainly on pledges of personal or real property is constantly applied to the foundation of banks in Germany. In the state of Indiana, about two years ago, the stoppage of the banks which followed exaggerated speculations in railways and trade was attended with serious losses to the holders of these notes, because, although undoubtedly good security for them existed in the shape of state securities, nevertheless the sudden contraction of the circulating medium caused a temporary fall in the price of them, which, occurring when it did, rendered the security so far illusory. The crises in America in the years 1854-5 were less serious than those that occurred in the years 1837 and 1839, since the former happened at a period when most of the undertakings commenced on credit were either completed or near completion. Both in America and England the tendency is increasing to use bank notes more

sparingly, and to substitute for them payments either in money, or in those species of promises to pay which have no tendency to mislead the holders as to their real nature and value. In Germany it seems as if we were entering on the opposite course, for we daily hear of new banks being privileged by the various governments to issue notes, which accordingly they do in great quantities, so that we appear to be on the road to that system of unrestrained speculations based on fictitious credit which in other countries has always preceded and led to great monetary crises.

Sir Robert Peel, in his parliamentary speech of March, 1844, expressed it as his opinion that free-trade should be allowed in all the branches of banking except as regards the issue of notes. The object of his measure was, first, to prevent the monetary crisis arising from the over-issue of bank notes, and, secondly, to furnish a standard for securing their convertibility into money. Peel considered that these ends could be accomplished only through the monopoly of one bank of issue, and he left to existing banks the faculty of issuing bank notes only in order to respect private interests then in being. The reason, indeed, given by Sir Robert Peel for not allowing free-trade in notes does not seem quite satisfactory. He observed that free-trade was desirable as a means of securing the greatest quantity of any given article at the cheapest rate, but that this was not the thing wanted as regards bank notes. Now it is undeniably desirable that notes should be as abundant and cheap as possible, provided only that for all practical purposes they are what they purport to be, namely, promises to pay money on demand, at once, and under all circumstances. But as it is not and cannot be the case that all notes are convertible into money, (for no bank, however solvent, could pay all its notes if presented at one time in a mass) it follows that the note *purports* to be something that in truth it is not. Hence the danger to the public arising from its very form and nature *as a note*; and inasmuch as the law for the public convenience not only permits but sanctions, and in so doing aids the circulation of these instruments of credit, it follows that the power which thus facilitates the *use* should, for the public safety, so far as it can, check and prevent the *abuse* of them. The reason given by Sir C. Wood in the debate of 1844 against leaving the issue of notes to free competition among banks seems to be the sound one, namely, that though such competition may tend to bring the over-issue back into due limits, yet it does not *prevent it at the outset*; the securing of which object is nevertheless essential in order to hinder the monetary crisis from arising. We must, however, bear in mind that no general *legislative* prohibition on this head will suffice, but that such perturbations of credit can be effectually prevented only by a prudent administration of the banking system. Thus in 1855 the directors of the Bank of England, acting with more prudence than in 1847, avoided a great crisis, though the law remained unchanged. But the legislation of 1844, though it did not *prevent* such crises as its authors expected, had in 1847 the effect of maintaining an unshaken trust in the notes of the Bank of England, so that the then crisis was ended, not by limiting the circulation of its notes, but by giving an authority to extend their issue.

In England and America various regulations have been made which in Germany have as yet never been thought of. Having, however, the experience of others before us, we surely should profit by it. I shall therefore state the means by which, in my opinion, similar catastrophes may be avoided with us. Legislative measures designed to hinder an over-issue can be effectual only so far as they extend to all places where the circulation of the notes extends; but such is not the case in Germany. Besides, such measures, taken by themselves, are insufficient to prevent the evil.

But preventive measures may be usefully instituted by common consent, and I propose the following, viz. :—

1. That the merchants of a city or a district should agree not to accept the notes of any bank of the solvency of which they are not satisfied.
2. That chambers of commerce, or, where none exist, respectable merchants chosen for that purpose, should report on this matter.
3. That the following should be universally taken as conditions, the compliance with which should be deemed indispensable before allowing the notes of any bank to circulate, namely :—

- (a) Separation of the issue of notes from all other departments, and giving distinct security for them.
- (b) Weekly publication of the state of the bank generally, and in especial of that of the issues.
- (c) Personal responsibility of the bank-directors for the correctness of its accounts and the administration.
- (d) The deposit with the government of pledges equal in value to the issue of notes, and capable of being easily realized.
- (e) The existence of a branch for cashing notes in every place where they circulate.

Of these conditions, the separation indicated in the first is especially important, as otherwise the security becomes illusory.

If all the affairs of a bank are under one undivided management, it is impossible to say how much of the capital is applicable to pay the note-holders, as distinct from the general creditors.

The weekly publication of accounts and the responsibility of the directors are also essential, especially when, as with us, the shareholders are only liable to the amount of their shares: and the sufficiency of the deposit, the facility of realizing it at any required moment, and the power of cashing the notes in each locality are equally important as guarantees to the public against the abuse of that species of credit which is represented by the issue of bank notes.
