

AN
ENQUIRY INTO THE NATURE
AND EFFECTS OF THE PAPER
CREDIT OF GREAT BRITAIN
(1802)

by
HENRY THORNTON

TOGETHER WITH HIS EVIDENCE GIVEN BEFORE THE COMMITTEES OF
SECRECY OF THE TWO HOUSES OF PARLIAMENT IN THE BANK
OF ENGLAND, MARCH AND APRIL, 1797, SOME MANUSCRIPT
NOTES, AND HIS SPEECHES ON THE BULLION REPORT,
MAY 1811

EDITED WITH AN INTRODUCTION
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F. A. v. HAYEK



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1 mars 2019 - Henry Thornton's life which throw light on the circumstances in which the Paper Credit of Great Britain was written, and on the influence which ...

CHAP. X

Objections to the Doctrine of the two preceding Chapters answered.—Of the Circumstances which render it necessary that the Bank should impose its own Limit on the Quantity of its Paper.—Effect of the Law against Usury.—Proof of the Necessity of restricting the Bank Loans, drawn from the Case of the Transfer of Capital to Foreign Countries.

SINCE it is not improbable that the reasoning of the preceding Chapters may have failed to produce full conviction in the mind of those who have been in the habit of deeming all limitation of the bank paper by the bank itself to be unnecessary; some few pages may be usefully employed in answering popular objections to the doctrine which has been laid down, and in more fully elucidating the subject.

(....)

We come next to the second topic of enquiry, namely, whether those bounds within which Bank of England paper must be confined, in order to guard against a dangerous depreciation of it, are likely to be observed, in consequence of some natural tendency which it has to limit itself, so that it is unnecessary that the bank should restrain it.

In examining this question, I mean also to enquire whether the adoption merely of such rules as may tend, in a general way, to confine the loans of the bank, may be sufficient; or whether, also, any limitation of the specific sums lent may be necessary.

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First, it is obvious that the principle of lending, simply in proportion to the property of those who desire to borrow, cannot be a safe one. If mere capital were to give a title to bank loans, the borrowers might become beyond measure numerous; even all proprietors of the public funds might prefer a claim for assistance.

If it should be said that the bank loans ought to be afforded only to traders, and on the security of real bills, that is to say, of bills drawn on the occasion of an actual sale of goods, let it be remembered that real bills, as was observed in an early part of this work, may be multiplied to an extremely great extent; and, moreover, that it is only necessary sufficiently to extend the customary length of credit, in order to effect the greatest imaginable multiplication of them.

If the bank directors were to measure their discounts by the amount of real bills offered, it may be apprehended, that bankers and other discounters, who now take this better kind of paper, might become much more considerable holders of mere notes of hand, or of fictitious bills; and that an opportunity might thus be afforded of pouring a vast additional quantity of real bills into the Bank of England.

It may be imagined, that if the directors were to govern their conduct by a regard partly to the capital of the borrowers, partly to the species of bills offered, but partly, also, to the probability of punctual payment, the addition of this third check to the former might suffice. But it is here to be recollected, that the bank itself, if we suppose a progressive enlargement of notes, must be assumed

to furnish perpetually increasing means of effecting payments, and thus to render punctuality in fulfilling even the most extravagant engagements convenient and easy to the merchants.

It only remains to enquire, lastly, whether any principle of moderation and forbearance on the part of borrowers at the bank may be likely to exempt the directors of that institution from the necessity of imposing their own limit.

It may possibly be thought, that a liberal extension of loans would soon satisfy all demands, and that the true point at which the increase of the paper of the bank ought to stop, would be discovered by the unwillingness of the merchants to continue borrowing.

In order to ascertain how far the desire of obtaining loans at the bank may be expected at any time to be carried, we must enquire into the subject of the quantum of profit likely to be derived from borrowing there under the existing circumstances. This is to be judged of by considering two points: the amount, first of interest

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to be paid on the sum borrowed; and, secondly, of the mercantile or other gain to be obtained by the employment of the borrowed capital. The gain which can be acquired by the means of commerce is commonly the highest which can be had; and it also regulates, in a great measure, the rate in all other cases. We may, therefore, consider this question as turning principally on a comparison of the rate of interest taken at the bank with the current rate of mercantile profit.

The bank is prohibited, by the state of the law, from demanding, even in time of war, an interest of more than five per cent., which is the same rate at which it discounts in a period of profound peace. It might, undoubtedly, at all seasons, sufficiently limit its paper by means of the price at which it lends, if the legislature did not interpose an obstacle to the constant adoption of this principle of restriction.

Any supposition that it would be safe to permit the bank paper to limit itself, because this would be to take the more *natural* course, is, therefore, altogether erroneous. It implies that there is no occasion to advert to the rate of interest in consideration of which the bank paper is furnished, or to change that rate according to the varying circumstances of the country.

At some seasons an interest, perhaps, of six per cent. per annum, at others, of five, or even of four per cent., may afford that degree of advantage to borrowers which shall be about sufficient to limit, in the due measure, the demand upon the bank for discounts.

Experience in some measure, proves the justice of this observation, for, in time of peace, the bank has found it easy to confine its paper by demanding five per cent. for interest; whereas, in war, and especially in the progress and towards the conclusion of it, as well as for some time afterwards, the directors have been subject, as I apprehend, to very earnest solicitations for discount, their notes, nevertheless, not being particularly diminished. It is, therefore, unreasonable to presume that there will always be a disposition in the borrowers at the bank to prescribe to themselves exactly those bounds which a regard to the safety of the bank would suggest.

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The interest of the two parties is not the same in this respect. The borrowers, in consequence of that artificial state of things which is produced by the law against usury, obtain their loans too cheap. That *which* they obtain too cheap they demand in too great quantity. To trust to their moderation and forbearance under such circumstances, is to commit the safety of the bank to the

discretion of those who, though both as merchants and as British subjects they may approve in the general of the proper limitation of bank paper, have, nevertheless, in this respect, an individual interest, which is at variance with that of the Bank of England.

The temptation to borrow, in time of war, too largely at the bank, arises, as has been observed, from the high rate of mercantile profit. Capital is then scarce, and the gain accruing from the employment of it is proportionably considerable.

The reader, possibly, may think that an extension of bank loans, by furnishing additional capital, may reduce the profit on the use of it, and may thus lessen the temptation to borrow at five per cent. It has been already remarked in this Chapter, that capital by which term *hond fide* property was intended, cannot be suddenly and materially increased by any emission of paper. That the rate of mercantile profit depends on the quantity of this *hond fide* capital and not on the amount of the nominal value which an increased emission of paper may give to it, is a circumstance which it will now be easy to point out.

I admit, that a large extension of bank loans may give a temporary check to the eagerness of the general demand for them. It will cause paper to be for a time over abundant, and the price paid for the use of it, consequently, to fall.

It seems clear, however, on the principles already stated, that when the augmented quantity of paper shall have been for some time stationary, and shall have produced its full effect in raising the price of goods, the temptation to borrow at five per cent. will be exactly the same as before; for the existing paper will then bear only the same proportion to the existing quantity of goods, when sold at the existing prices, which the former paper bore to 255

the former quantity of goods, when sold at the former prices: the power of purchasing will, therefore, be the same; the terms of lending and borrowing must be presumed to be the same; the amount of circulating medium alone will have altered, and it will have simply caused the same goods to pass for a larger quantity of paper. To assume under such circumstances the same rate of mercantile profit to subsist, is only to suppose that the trader will be situated neither more nor less advantageously than before; and that the annual gain which he will obtain by trading with the same quantity of goods, will bear the same proportion as before to their current cost. If this observation be just, there can be no reason to believe that even the most liberal extension of bank loans will have the smallest tendency to produce a permanent diminution of the applications to the bank for discount. It is the progressive augmentation of bank paper, and not the magnitude of its existing amount, which gives the relief. It thus appears, that the moderation and forbearance among borrowers, which were supposed likely to restrain the too great emission of paper, are only to be excited by the means of its perpetual increase; by the means, that is to say, of the very evil which it was assumed that they would be sufficient to prevent.

The danger of enlarging the loans of the bank in proportion to the extension of the demand for them, may be more particularly shewn by adverting to the case of the sudden transfer to foreign countries of capital which had been antecedently lodged in this. Let us suppose the foreign owners, either of British stocks, or of property left in the hands of English correspondents, to draw during the space of three months to a very large amount; and let us imagine that, in consequence of such an event, the exchange turns against

Great Britain to the extent of five per cent.; and moreover that at the end of the three months, the drafts ceasing, and the mercantile state of the country improving, the exchange returns to its proper level. In this case any Englishman, who can send goods abroad on his own account, and draw for them during the three months in question, will gain an extra profit of five per cent.,

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supposing him to buy them in England for the same English money and to sell them abroad for the same foreign money, for which goods may be bought and sold at the periods preceding, and following the interval of time of which we are speaking. A similar extra profit will be obtainable during the same three months by a variety of other modes of employing capital. It is obvious, for example, that the public funds may be expected to experience a sudden fall through the great sale of foreign property in the stocks, which we have imagined to take place. He, therefore, who shall buy into the funds at the season of depression, and shall sell out at the expiration of the three months, will be likely to derive a benefit from this species of speculation. It is also plain that the quantity of goods in Great Britain will be reduced through the enlarged exportations, as well as through the suspension of imports to which the state of the exchange will have given occasion. The profit, therefore, on the use of the remaining stock will be generally augmented. The exportation of bullion will afford a gain of the same sum of five per cent. the expense of transporting it being, indeed, deducted. The demand upon the bank for discounts is, therefore, likely to be particularly earnest during the period of which we are speaking; and it is important here to notice, that the ground on which it will be made will not be that which was spoken of in an early part of this work. It will not be the privation of that quantity of circulating medium which is necessary for carrying on the accustomed payments, for these will be very immaterially increased; the cause of the extraordinary applications to the bank will be the temporary advantage which may be gained, or the loss which may be avoided, by borrowing, during the three months in question, at the rate of five per cent. A pressure, it is true, may be occasioned by the multitude of foreign drafts, and it may resemble that which would arise from a diminution of Bank of England paper. Some of those merchants in whose hands the foreign property had been placed may not be able, with sufficient readiness, to spare from their commerce the sums necessary to answer the bills drawn upon them. Creditors, not being permitted to demand more than five per cent. interest

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from their debtors, are apt, at particular junctures, to call in their money, for the sake of taking to themselves the extraordinary benefit to be obtained by the use of capital. The disappointments thus brought on persons trading with borrowed wealth are often productive of much evil. The maintenance of the accustomed quantity of Bank of England notes may, therefore, be insufficient to furnish the means of securing the usual regularity of the payments of the metropolis; and a material diminution of paper may be particularly inconvenient. Possibly an augmentation of it may be necessary to the due maintenance of credit. If we suppose, however, a very great increase of bank notes to take place (and an increase, probably, equal to the total capital transferred on account of foreigners, will immediately be desired), the result must be a very important fall in the exchange, in addition to the fall of five per cent. already mentioned; and a new and proportionate danger to the Bank of England.

The point which it has been the object here to explain, might

have been equally illustrated by imagining either the case of a strong disposition in many British subjects to transfer their own property to foreign countries, in order to lodge it there; or the case of a general eagerness to extend foreign commerce; for we must assume the transfer to foreign parts of an additional British capital to take place on either of these suppositions.

The preceding observations explain the reason of a determination, adopted some time since by the bank directors, to limit the total weekly amount of loans furnished by them to the merchants. The adoption of a regulation for this purpose seems to have been rendered necessary by that impossibility of otherwise sufficiently limiting, at all times, the Bank of England paper, which it has been the design of this Chapter to point out.

The regulation in question I consider as intended to confine within a specific, though in some degree fluctuating, sum, the loans of the bank, for the sake of restricting the paper. The variations in the amount of loans fail of producing exactly correspondent variations in the amount of paper, in proportion as the gold of the

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bank fluctuates. But the regulation being a weekly one, opportunity is afforded of correcting this attendant imperfection before any material evil can have arisen. The changes which occur in the amount of the loans to government form another ground for taking into weekly consideration the sum which shall, in the succeeding week, be afforded to the merchants.

To limit the total amount of paper issued, and to resort for this purpose, whenever the temptation to borrow is strong, to some effectual principle of restriction; in no case, however, materially to diminish the sum in circulation, but to let it vibrate only within certain limits; to afford a slow and cautious extension of it, as the general trade of the kingdom enlarges itself; to allow of some special, though temporary, increase in the event of any extraordinary alarm or difficulty, as the best means of preventing a great demand at home for "guineas;" and to lean to the side of diminution, in the case of gold going abroad, and of the general exchanges continuing long unfavourable; this seems to be the true policy of the directors of an institution circumstanced like "that of the Bank of England. To suffer either the solicitations of merchants, or the wishes of government, to determine the measure of the bank issues, is unquestionably to adopt a very false principle of conduct.

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