Notes on Banks, Paper Money, and Finance

18th Century Banks

Banks in 18th century Britain were, in many ways, similar to modern banks: they took deposits, on which they paid interest; they made loans, on which they earned interest; and they made a profit on the difference between interest earned and interest paid out.

But there were also important differences. With the exception of the Bank of England, banks were partnerships not, as modern banks are, limited-liability corporations. Banks were limited to six partners, and each was liable for the debts of the bank. If, therefore, a bank became insolvent, everything that the partners owned could be taken to pay the debts of the bank.

Another important difference was that banks could issue their own banknotes, which circulated as paper money. One way to understand an 18th century banknote is to think of it is as a cashier's check (i.e., as check that written against the bank's own account rather than against a depositor's account). Rather than being payable to a specific individual, think of them as payable to cash. (Even today, we may write a check to "Cash," and anyone holding that check may deposit it or receive currency from the bank for it.) Until quite recently, British (and American) banknotes still had a statement written on them saying that the bank promised to pay the bearer money in the amount indicated on the note. The difference in the 18th century was that such a promise would be redeemed in gold or silver coin.

In Scotland in Smith's time, paper banknotes almost completely supplanted coins. Unlike today, since banknotes were not a government monopoly, it was possible that their value could collapse if the bank became insolvent and could not redeem the notes. As a result, some banks were regarded as more trustworthy than others, and banknotes might not actually exchange one for one with each other nor with coin, as people might demand a discount for a banknote that they perceived as risky.

Paper money was less well established in England than in Scotland. One reason was that the Bank of England held a monopoly on issuing banknotes in the greater London area, and London was, then, as today, by far the most important area of England economically.

The Bank of England was (until 1946) a private, joint stock bank. It was chartered as a limited-liability company, so that it had many more investors than typical "country banks." It was much larger than any other British bank. Its business was divided into two parts: one more or less that of an ordinary bank; one essentially the same as a modern central bank. In this latter role, it was the banker to the government and a central player in the management of the government's debt; and it was a banker to the plethora of smaller banks, which could treat holdings of Bank of England notes and accounts at the Bank of England as fundamentally the same as holdings of legal-tender coin.

Bills of Exchange

Smith mentions the longer-term loans of banks to businesses for the purpose of financing fixed capital expenditures. These loans usually took the form of mortgages that were secured by the property, buildings, or machinery that they were used to finance. Essentially, such mortgages were the same as modern mortgages.

Smith also discusses in some detail, short-term *bills of exchange*, which were the major financial instrument used in financing day-to-day business operations. (Bills of exchange still exist today, although we hardly hear about them, even in finance courses.) Again, we can understand bills of exchange as a kind of check. A manufacturer might sell a product to a retailer or an exporter. Frequently, the buyer would not have ready cash, but would expect to receive cash when the goods were resold. The buyer might then write a check to the seller, but date the check for some time later (say, 30 or 90 days in the future). The check would be written payable to the seller. Generally, the seller would charge a higher price for goods paid in this way than for goods paid in cash. That would be a form of implicit interest. Such a check is legally a direction of the buyer to his bank to pay the seller (so, there are three parties involved). The classic bill of exchange takes exactly the same form as such a check, but some additional legal details may be different.

A seller who has *accepted* and holds a bill of exchange might wish to have cash sooner than the date on the bill. In that case, he could sell it to a third party. The third party would usually pay less than the face value on the bill, which is why such purchases are referred to as *discounting*. By paying less than the face value, the third-party buyer effectively earns interest from holding the bill. When a bill is discounted, the original holder endorses it – just as one would endorse a check. The bill may be sold again (*rediscounted*) with the current holder adding an endorsement. Each endorser guarantees the value of the bill to the party to whom it is sold. Thus, the bill gains security as it is passed from party to party; since, if one endorser fails to honor the bill, the next endorser down the line become legally liable. The money markets of London and other major financial centers traded bills of exchange actively.

Foreign Exchanges

If every country were on a gold standard (or other metallic money standard), the coins of each country could in principle trade in proportion to the amount of pure gold in each. This was complicated in practice by two factors.

First, a British guinea (a gold coin worth 1 pound 1 shilling) would typically trade in Britain at its face value (i.e., by tale), even if it were worn and, therefore, had less than its nominal weight in gold. But if it were taken to, say, Amsterdam, it would be received according to its weight. As a result, traders would systematically reserve the worn (light coins) for domestic use and use the heavy coins for foreign trade. This is the original situation referred to as Gresham's Law: "bad money [i.e., worn coin] drives out good [i.e., full-weight coin]."

Second, in Britain someone holding gold bullion or gold foreign coins could, by right, exchange them by weight for new, full weight British coins at the mint. That is, the mint did not charge for the cost of turning raw gold into coin. Most other countries, however, levied a charge for coining gold, which is referred to as *agio* and was calculated as a percentage of the face value of the coins into which it could be minted. The existence of agio meant that, in those countries, coins traded at a premium over their weight in gold. This implied that British coins would not exchange one for one with foreign coins in their home markets, but would exchange at a discount to reflect the agio.

Coins, however, were awkward to use in foreign exchange. They were heavy and clumsy, especially in large quantities. To ship them required guards against theft and insurance against shipwreck and other risks. Bills of exchange provided an alternative. A British merchant selling goods in Amsterdam might accept a bill of exchange payable against an Amsterdam bank in Dutch guilders. Of course, he would not want to actually take payment in guilders, nor would he want to ship guilders back to England. Instead, he might find a Dutch merchant who held a bill of exchange payable in London in pounds sterling and trade the one for the other. In practice, that would prove awkward between two random merchants, as it would be hard to find parties with bills of exchange with the desired face value and due date. Instead, a foreign exchange market developed in which banks would discount bills of exchange in one currency – just as they would for domestic transactions –for bills of exchange in the merchant's desired currency payable in their own country. These bills could then be carried, say, from Amsterdam to London – more easily than could gold or silver – and either redeemed when due against a London bank or rediscounted. Banks in the financial centers of important trading countries would maintain correspondent relations with banks in other countries to facilitate these exchanges.

In the 18^{th} century, the foreign exchange rate refers to the rate at which bills of exchange in one currency exchange for those in another currency. If there were an excess supply of bills in pounds sterling relative to the demand for bills in guilders, the pound would depreciate (£1 would purchase fewer guilders) and the guilder would appreciate (i.e., purchase more pounds). If the exchange rate for bills exceeded the underlying ratio of gold in the national coins (adjusted for agio), the exchange rate was said to be a *premium*; and, if it fell short of the gold ratio, it was said to be at a *discount.* Exchange rates could vary considerably from day to day. However, if the pound traded at too much of discount, it might become profitable to actually ship gold guineas to Amsterdam, as they would purchase more guilders than a bill of exchange of the same face value. The possibility of actually shipping gold placed a limit on how far exchange rates could vary, unless there were exceptional circumstances, such as war, that heightened the risks of loss from shipping gold, or legally restricted gold exports altogether.