

# THE FINANCIAL ORGANIZATION OF SOCIETY

BY

HAROLD G. MOULTON

DIRECTOR OF THE INSTITUTE OF ECONOMICS  
WASHINGTON, D.C.

SECOND EDITION



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## EDITOR'S PREFACE

Collegiate training for business administration is now so widely attempted that the time has arrived when experiments should be conducted looking toward the organization of the business curriculum into a coherent whole. Training in scattered "business subjects" was defensible enough in the earlier days of collegiate business training, but such a method cannot be permanent. It must yield to a more comprehensive organization.

There can be no doubt that many experiments will be conducted looking toward this goal; they are, indeed, already under way. This series, "Materials for the Study of Business," marks one stage in such an experiment in the School of Commerce and Administration of the University of Chicago.

It is appropriate that the hypotheses on which this experiment is being conducted be set forth. In general terms the reasoning back of the experiment runs as follows: The business executive administers his business under conditions imposed by his environment, both physical and social. The student should accordingly have an understanding of the physical environment. This justifies attention to the earth sciences. He should also have an understanding of the social environment and must accordingly give attention to civics, law, economics, social psychology, and other branches of the social sciences. His knowledge of environment should not be too abstract in character. It should be given practical content, and should be closely related to his knowledge of the internal problems of management. This may be accomplished through a range of courses dealing with business administration wherein the student may become acquainted with such matters as the measuring aids of control, the communicating aids of control, organization policies and methods; the manager's relation to production, to labor, to finance, to technology, to risk-bearing, to the market,

## BASIC ELEMENTS OF THE BUSINESS CURRICULUM

## CONTROL

1. Communicating aids of control, for example
  - a) English
  - b) Foreign language
2. Measuring aids of control, for example
  - a) Mathematics
  - b) Statistics and accounting
3. Standards and practices of control
  - a) Psychology
  - b) Organization policies and methods

Of problems of adjustment to physical environment

- a) The earth sciences
- b) The manager's relationship to these

Of problems of technology

- a) Physics through mechanics, basic, and other sciences as appropriate
- b) The manager's administration of production

Of problems of finance

- a) The financial organization of society
- b) The manager's administration of finance

Of problems connected with the market

- a) Market functions and market structure
- b) The manager's administration of marketing (including purchasing and traffic)

Of problems of risk and risk-bearing

- a) The risk aspects of modern industrial society
- b) The manager's administration of risk-bearing

Of problems of personnel

- a) The position of the worker in modern industrial society
- b) The manager's administration of personnel

Of problems of adjustment to social environment

- a) The historical background
- b) The socio-economic institutional life
- c) Business law and government

to social control, etc. Business is, after all, a pecuniarily organized scheme of gratifying human wants, and, properly understood, falls little short of being as broad, as inclusive, as life itself in its motives, aspirations, and social obligations. It falls little short of being as broad as all science in its technique. Training for the task of the business administrator must have breadth and depth comparable with those of the task.

Stating the matter in another way, the modern business administrator is essentially a solver of business problems—problems of business policy, of organization, and of operation. These problems, great in number and broad in scope, divide themselves into certain type groups, and in each type group there are certain classes of obstacles to be overcome, as well as certain aids, or materials of solution.

If these problems are arranged (1) to show the significance of the organizing and administrative, or control, activities of the modern responsible manager, and (2) to indicate appropriate fields of training, the diagram on the opposite page (which disregards much over-lapping and interacting) results. It sets forth the present hypothesis of the School of Commerce and Administration concerning the basic elements of the business curriculum covering both secondary school and collegiate work.

The present volume in the series is designed to give the student an understanding of the financial institutions which the manager utilizes and which largely condition his financial policies. It presents one phase of his social environment.

L. C. MARSHALL

## PREFACE TO SECOND EDITION

The five-year period since the appearance of the first edition of this volume has been marked by financial changes of exceptional interest and importance. In this edition the factual and statistical material have not only been brought up to date, but the significant financial developments of the post-war era have been incorporated as an integral part of the text. Thus the material in the chapters on "Money" has been amplified by illustrations drawn from recent European experiences. The chapter on "The Foreign Exchanges" has been extended to take account of post-war depreciation and the problems involved in a return to exchange stability. The chapter on "Foreign Investment Trusts" has been almost entirely re-written under a new heading, "The Marketing of Foreign Securities." "The War and the Federal Reserve System" has become "Ten Years of the Federal Reserve System." An entirely new chapter has been added on the very important problems of "Urban Real Estate Financing." The chapter on "Raising Capital for Agriculture" has been thoroughly recast in order to take account of the Federal Intermediate Credit System, established in 1923. Recent developments in the field of consumption and co-operative credit have also been incorporated, including the labor bank movement. Finally, in place of the old chapter i is an Introduction to Teachers, the purpose of which is to explain how a treatise entitled *The Financial Organization of Society* came to be written, and to indicate in what ways the author regards it as an advance over the traditional treatise on *Money and Banking*.<sup>1</sup>

In the preparation of this edition, the author has benefited by the criticism of numerous teachers who have used the previous edition. He is greatly indebted to Claude L. Benner, of the

<sup>1</sup> The Introduction originally appeared in a modified form as an article in the *Journal of Political Economy* (1922).

Institute of Economics, for assistance in revising the chapter on "Raising Capital for Agriculture"; indeed, Mr. Benner has contributed all of the content and much of the form of the section dealing with the Federal Intermediate Credit System. Forrest M. Larmer, of Des Moines, and Howell W. Murray and John B. Perlee, of Chicago, who, out of their practical experience, respectively in cattle loan, commercial paper, and discount company financing, had aided me in the preparation of the original edition, have again given me the benefit of suggestions and criticisms. Finally, without the efficient assistance of Richard N. Owens, of Emory University, in connection with every phase of the revision, a new edition at this time would scarcely have been possible.

HAROLD G. MOULTON

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## INTRODUCTION TO TEACHERS

This volume differs from the usual textbook in the field of finance both in scope and in point of view. In the thought that it may prove useful to teachers to know something of the evolution of a course and textbook entitled *The Financial Organization of Society*, I present at this place an account of the development of my own thinking on the subject.

I should perhaps state at the beginning that my present formulation of such a course is the result of many years of experimentation. I can perhaps best make clear the reason for my present views by relating my personal experience in teaching the subject. I was trained in the classical school of economics; and accordingly, when early in my teaching career I was asked to give a course in "Money and Banking," I eagerly seized the opportunity presented to instruct my students in the accepted principles of the science. In brief, on the money side I gave them the functions of money, the history of bimetallism, and the regulation of the various forms of metallic and paper currency; and on the banking side I discussed the functions of commercial banks in creating bank notes and deposit currency, the problems of regulation in the United States, and the superiority of European central bank systems. Finally, I gave them the "true theory" of the relation of money and bank currency to prices.

But I found the subject a somewhat difficult one to teach—on the whole, rather dull and uninteresting to the students. Whether this was attributable to the fact that in the elementary course in economics they had already been set straight on the functions of money, bimetallism, bank credit, and the quantity theory, or whether the exposition of the inherently practical and fascinating field of finance had fallen into an academic and unrealistic form, I have never quite made up my mind. In any event my students were never sufficiently thrilled over this

course to cause me any regrets when in due time I was led to undertake a reorganization not only of the course in money and banking but also of the entire field of finance.

My first experiment was an attempt to make a general course in money and banking serve as a satisfactory prerequisite to advanced studies in the field. In brief, my experience convinced me that many of the specialized advanced courses in the field of finance could not well be built upon the traditional introductory course in money and banking—owing to its extremely limited scope. Moreover, the traditional course seemed, to my students at least, highly academic and without much practical relation to real business and financial affairs, except here and there in particular sections, such as those dealing with the practical operations of a commercial bank and the nature and purpose of the Federal Reserve System. So considerably have I subsequently changed the scope of the general-survey course that I feel it necessary to lay especial emphasis upon what I now conceive to be the limitations of the traditional treatment of money and banking.

## I. SHORTCOMINGS OF THE TRADITIONAL TREATMENT OF MONEY AND BANKING

The place of money and banking in the orthodox treatment of political economy may be briefly set forth somewhat as follows: Economics is divided into the four broad divisions of consumption, production, exchange, and distribution. Human wants constitute the point of departure, the desire for consumptive goods being the mainspring of human activity and productive effort. Then are discussed the fundamental factors of production—labor, land, capital, and management. Having gotten the goods produced and on the market, the problem of evaluation for the purposes of exchange arises, and this leads to a discussion of the laws of value. Speaking of exchange, one is reminded that money serves as a standard in which exchange values are expressed and a medium by which the ownership of goods on the market is transferred. And speaking of money as a medium, one

must also note that there are various kinds of money, among them being bank money, both notes and deposit currency. Having gotten these goods produced and exchanged, it is next in order to consider the division of the social dividend among the various agents of production—land, labor, capital, and management, respectively. In elucidating the principles of economics in accordance with this division of the subject matter, most writers leave the impression that money is largely, if not wholly, divorced from the productive process.

Some writers, it is true, relate money to the productive process by including in the classification of utilities, *possession* utilities. As goods are not fully produced when they leave the factories or the farms, they must be transported, hence *place* utility; they must often be stored, hence *time* utility; and, finally, their ownership must be transferred in the market place, hence *possession* utility. Money as a medium of exchange—for the transfer of ownership—thus serves in the final stage of the complex productive process. But the text which indicates that in this way money plays a direct part in production still leaves the relation of money to economic organization anything but adequate. The analysis would indicate that money is of service only in the last stage of the productive process, in connection with the exchange of finished goods between producer and consumer. What is not deducible from such analysis is that money is also the means of organizing production, of bringing together the various agencies of production (land, labor, capital, and managers), and fusing them into a business organization that can turn out a product capable of ministering to human wants.

Society is now organized on a pecuniary basis, and money is the indispensable prerequisite to the assembling of the concrete instruments of production. The business man uses money, or its equivalent, to purchase materials for the construction of his factory; he uses his money in buying the supplies and materials necessary for its equipment; he bids competitively in the markets of the world for the raw material used in the process of manufacturing; and he employs money as a means of attract-

ing to his organization the requisite labor force and corps of administrative officials. In short, every act of the productive process itself revolves about the use of money. There is, of course, nothing particularly new in this statement of the case. What is interesting is that the writers of general treatises on economics have usually regarded it as unnecessary to make any mention of the part that money plays in the organization of productive activities, thereby giving the whole subject a very imperfect as well as unrealistic presentation.

The special treatises on money and banking which follow the traditional conception laid down in the general texts—that money is used in *exchanging* goods produced through the united effort of land, labor, capital, and management—in similar fashion make no reference to the part that money plays in the organization of productive activities. In connection with the function of money as a common denominator of value, the current statement is that the existence of a common denominator or standard of value saves the individual the necessity of burdening his weary mind with innumerable exchange ratios. This method of stating the significance of the common denominator of value results from the traditional practice of discussing money only under the heading of “exchange.”

But when one shifts the point of view from the significance of money in exchanging consumptive goods that have already been produced to the part that a common denominator of value, or pecuniary unit of calculation, plays in the organization of productive activity, it becomes readily apparent that money in this capacity also plays an extremely important rôle in the field of production. The truth is that without a common denominator of value—or pecuniary unit—it would be impossible to keep financial accounts or to give commensurability to unlike units of consumptive goods, capital goods, labor power, what not. Without the pecuniary unit all other units of measurement would be valueless for the purposes of business. As a qualitative unit of measurement, the dollar serves as a guide to the business man in the development of new methods and new technique—in a word,

in the making of the innumerable decisions which he must render from day to day. The price-and-profit system based on the pecuniary unit serves as a guide in the directing of labor and capital from place to place and from industry to industry. Accounting systems based on the dollar unit also make possible governmental supervision and control of industrial affairs (see chap. i). All this finds no place, however, in the traditional discussion of the rôle of money in economic activity, despite the pretension that the analysis is disclosing the way in which society has organized itself for the production of wealth.

In connection with the standard of deferred payments, somewhat more attention has been given to the relation of money to business activities in the field of production. For it is not infrequently pointed out that a poor standard of deferred payments is a great deterrent to business enterprise, owing to the increased business risks that result therefrom. But even in this case the relation of the standard of deferred payments to the conduct of business is usually treated as an incidental feature. The emphasis is rather placed upon the relation of the standard of deferred payments to prices. And in discussions of the price level the emphasis is placed upon the equities between debtors and creditors in connection with long-time borrowing operations and upon the effects of changing prices upon the various classes of the community. The question of just distribution is apparently the primary consideration, while the importance of a stable standard from the standpoint of production is scarcely noted.

The problems of securing a stable standard of deferred payments, and the maintenance of the various forms of token and representative currency at a parity with this standard, have been among the most fascinating inquiries in the whole realm of political economy and by many have come to be regarded as about the only significant financial issues that need concern the economist. As a professional friend of mine once said: "The economist's problem is the price problem. Why should he therefore concern himself about other financial issues?" The obvious

answer is that it is only one of the many problems of vital interest to the economist who would understand the significance of money in industrial society. The perennial controversies that have raged about the relation of money to prices have, however, tended to shift the emphasis away from other important monetary considerations and to obscure the rôle that money plays in connection with the organization of economic activity.

So much for the shortcomings of the traditional discussions of money. My efforts to organize a general-survey course in money and banking revealed an even greater difficulty or weakness on the banking side. For, as already indicated, the emphasis upon money and its relation to prices has led to confining the discussion of banking to commercial banking only—this for the reason that commercial banking alone provides, in bank notes and deposit currency, media that are acceptable in exchanging goods. In consequence, the whole discussion of banking, with the exception of a brief section devoted to financial panics, has usually centered around the maintenance of the parity of bank currency with gold, the function of bank currency in exchanging goods, and the relation of bank credit to prices. I trust I will not be understood as objecting to such discussion; my point is merely that this narrowing of the scope of banking has rendered the traditional treatment of finance quite inadequate for the purposes of the business curriculum or, for that matter, for the purposes of the general economics curriculum. For example, one repeatedly finds the doctrine that the commercial bank should (properly) function only in connection with commerce—with the marketing process, whereby the economic gap between producer and consumer is bridged. This is not only inadequate theory; it embodies a fundamentally erroneous conception of the nature of the modern business and financial organization.

## II. SHORTCOMINGS OF MY COURSE IN “FINANCIAL INSTITUTIONS”

The numerous financial agencies and institutions other than the commercial bank which are found in modern economic soci-

ety did not naturally fall within the scope of this traditional theory of the rôle of money and banking in the economic system. Accordingly, we usually find only incidental reference to them, either in the general texts on economics or in the special works in the field of money and banking.<sup>1</sup> It was not surprising, therefore, that one should find, as I did, that the traditional study of commercial banking did not serve as an adequate basis for a survey course in the financial field. Somehow or other, the large number of other financial institutions and agencies which had grown up in modern times and which are made use of by the business man of today must be brought into the picture. I therefore conceived the idea of a general-survey course which was designated "Financial Institutions."

In brief, the idea of the course on "Financial Institutions" was to disclose to the student the nature and the functions of all the financial agencies and institutions that exist in the modern world. Money, in its various functions, was considered—as also the work of commercial banks, savings banks, investment banks, insurance companies (in their banking aspects), the stock exchanges, etc. But the difficulty here was that one was tempted either to include within a single course everything that had been discussed in the whole series of specialized courses in the various divisions of finance—a task to be despaired of—or else to make the course a very elementary one, designed merely to give the student a bird's-eye view of financial problems and of the financial system in general. There was, indeed, grave danger that it would be of so elementary and fragmentary a nature as to be sadly wanting in genuine intellectual content.

Experience showed that what was really needed was not a series of discussions of the several financial institutions in turn, but an analysis which would reveal the broad outlines and the significance of the financial system conceived as a unit and as an integral part of the general economic organization. The individual financial institutions all needed to be related in some

<sup>1</sup> In recent years, however, there has been a tendency for writers of special treatises to devote some attention to savings banks, etc.

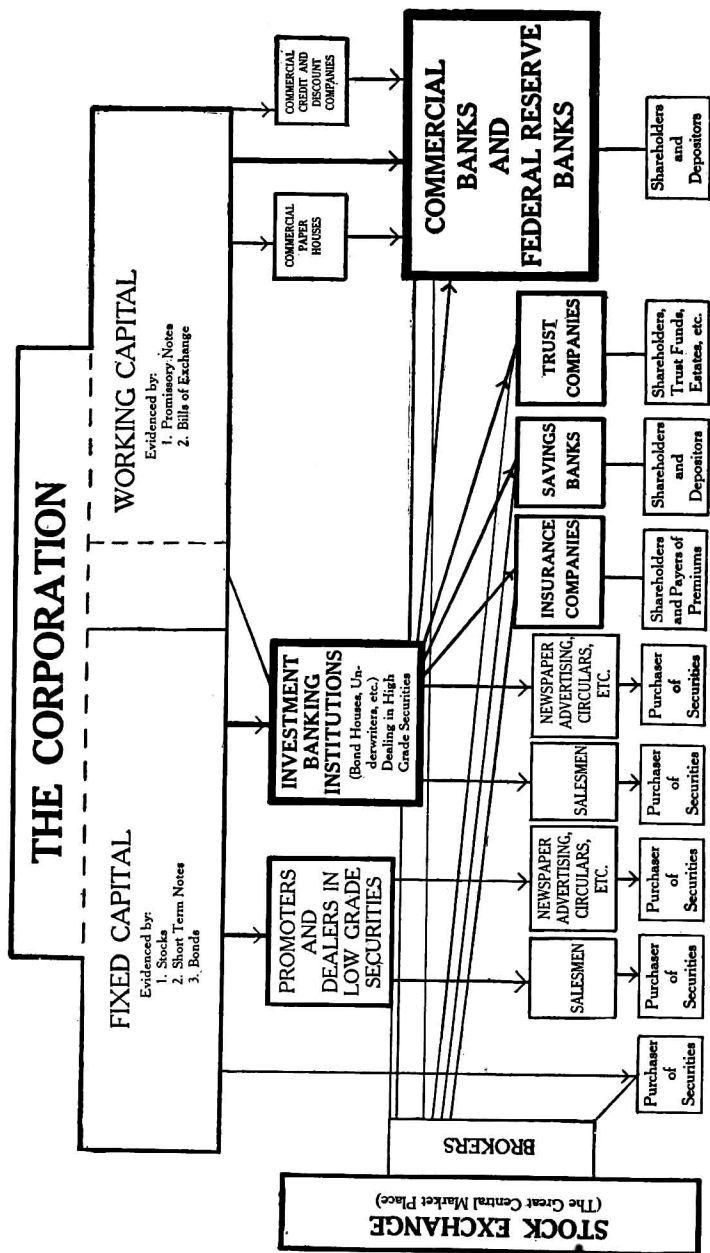
fashion as parts of a general financial structure. The tie that binds must somewhere be sound if a general-survey course in finance were to be worthy of the name. This discovery explains the change of emphasis from financial institutions to financial organization.

### III. THE DIFFERENCE BETWEEN FINANCIAL ORGANIZATION AND FINANCIAL INSTITUTIONS

In a treatise on financial organization the various financial agencies and institutions are still described; but their relations one to another as parts of a larger financial structure, and the general setting of this financial system within the larger economic organization, are also disclosed. A diagrammatic presentation of that portion of the financial structure which is related to corporate enterprise is shown on the accompanying page.

The purpose of this diagram is to indicate that in a capitalistic, pecuniary, society all of the financial institutions and agencies which exist have been developed for the purpose of facilitating the raising of the capital (funds) required by modern business enterprises. For purposes of exposition this capital is divided into fixed and working capital. The fixed capital is raised through the sale of stocks, short-term notes, and bonds—the funds being derived from the ultimate purchasers of these securities, that is, from the rank and file of individuals and investing institutions. Sometimes the purchaser of securities is reached directly, without the help of any financial intermediary; sometimes he is reached through promoters and dealers in low-grade securities; and sometimes through investment banking institutions dealing in high-grade issues. These institutions in turn utilize salesmen, newspaper advertising, circulars, etc. And insofar as securities are purchased by insurance companies, savings banks, trust companies, and commercial banks, these institutions serve as secondary intermediaries between the furnisher of the funds and the borrowing corporation.

The stock exchange appears at one side as a great, central



market place, alike for securities that have once passed through the hands of financial middlemen to purchasers, and for securities that have not been finally absorbed by the investing public but are still being carried in the speculative market. The transverse lines connecting the stock exchange with the purchaser of securities and with other financial institutions are designed to suggest that interrelations exist between these institutions. It will be noted, also, that the diagram indicates that some of the funds derived from the sale of stock, short-term notes, and bonds are used for working-capital purposes. (Note the dotted line through the working-capital side of the chart.)

On the working-capital side, the chart indicates that corporations borrow funds for operating expenses from commercial banks—much of it directly, but some of it indirectly through the intermediation of commercial paper houses and commercial credit or discount companies. The transverse lines connecting the commercial banks and the Federal Reserve institutions with investment banking institutions and the stock exchange are designed to indicate interrelations in the financial system, some of which will presently be discussed.

For the moment, what needs emphasizing is that these financial institutions are all engaged in a common task of transferring the funds of the ultimate savers of society listed at the bottom of the diagram to the borrowing corporation which is placed at the top! Together these institutions constitute a financial structure; they make up the component parts of the modern financial system about which all economic activities center—on the basis of which industrial society is organized.

The advantage in organizing a survey course in finance around this central problem of raising fixed and working capital for modern business uses is that one may thus see at a glance the relation of the individual business to each and every part of the financial system. The modern business has its setting in the midst of a financial system upon which it is at all times and in manifold ways dependent; and a sound financial policy can be formulated only in the light of knowledge of the services ren-