In the 19th century a saying was current on Lombard Street that went like this: “There is nothing easier in the world than the banker’s profession – provided that he can tell a real bill and a mortgage apart.”

I would like to engage Dr. Joseph Salerno in a friendly debate on this maxim. In his interview with the Daily Bell published July 3, 2011, he sees nothing wrong with people drawing bills of exchange, or accepting them in payment, as these instruments are completely consistent with a society based on free contract. I heartily welcome this statement of his. It should be much more widely known. After the death of the dollar people in the United States, and in other countries wherever the dollar also circulates, will not want to die along with the currency. They will still want to eat, get clad, shod, and keep themselves warm in winter. In order to be able do so they will just have to draw bills on retail merchants and other producers whom they supply with finished or semi-finished goods. These bills will serve as cash with which to buy food, clothes, shoes, fuel. We may expect that banks, central or otherwise, will have earned themselves such a bad name by then that nobody will want to be known as a ‘banker’. ‘Bill-monger’ will sound much more honorable.

Dr. Salerno adds: What I vigorously reject is the age-old fallacy known as the ‘real bills doctrine’ asserting that when a bank issues currency or creates a bank deposit in discounting a bill of exchange, it is not causing inflation. In the next sentence he clarifies his position further when he suggests that whether a fractional-reserve bank buys a mortgage, or whether it discounts a real bill, it comes to the same thing: the bank increases its demand deposit liabilities to finance the expansion of assets.

While this is true, it does not prove that the bank is guilty of causing inflation when discounting a real bill. The difference is this, and in ignoring it Dr. Salerno dodges the real issue here: when the bank discounts a real bill, it withdraws from the market an instrument that circulates as money. Ephemeral, to be sure, but money nevertheless. Ludwig von Mises, no friend of the real bills doctrine, admits that bills of exchange have circulated as a means of payment among spinners, weavers and other tradesmen dealing in cotton products in Lancashire before the Bank of England opened its branch in Manchester.

There was a time not too many years ago when it was strictly against the rules for a commercial bank to put a mortgage in its portfolio of assets. You have never ever seen a mortgage, or an elephant for that matter, fly. Real bills, by
contrast, can and do circulate on their own wings and under their own steam as currency. The present Great Financial Crisis started with commercial banks overloading their portfolio with mortgages disguised as ‘securitized equity’. Yet no one is inquiring whether the violation of the old time-tested rules has caused the crisis in the first place.

In discounting a real bill the banker only substitutes his own credit that has a higher name-recognition. The potent ingredient of the credit is that of the weaver, even though it has a lower name-recognition. The searching question to ask therefore is this: does the weaver really cause inflation when he passes along the bill he has drawn on the fabric merchant to the spinner in payment for the yarn?

I hope Dr. Salerno agrees with my answer: no, the weaver causes no inflation. It is true that he puts a purchasing medium, his bill drawn on the fabric merchant into circulation, but it is matched by the cloth, a new merchandise of the same value he offers for sale. The bill and the cloth appear simultaneously and will disappear simultaneously. The former disappears when it matures, and the latter disappears when it is purchased by the ultimate consumer. An increase in purchasing media that is matched by an increase of merchandise in urgent consumer demand is not inflationary.

Bankers of old on Lombard Street expressed this by saying that the credit embodied by a real bill is self-liquidating as it is extinguished by virtue of the sale of underlying merchandise on which it is drawn. By contrast, the credit embodied by a mortgage is not self-liquidating as it is not normally extinguished out of the proceeds of the sale of the underlying property.

Dr. Salerno also makes a comment on the suppression of the rate of interest, allegedly caused by bankers in discounting real bills at a discount rate lower than the rate of interest. This suppression, he suggests, generates an unlimited supply of bills to discount, causing an inflationary spiral of money-creation and price increases.

Mises explicitly stated that the discount rate is just another name for a short-term interest rate with interest taken out of the proceeds of the loan up front. However, this description is mistaken, as pointed out by several authors, among others John Fullarton and Charles Rist. The nature and origin of the discount rate are entirely different from that of the rate of interest. The two rates are completely independent of one another. The rate of interest is determined by the propensity to save; the discount rate by the propensity to consume. In either case the relationship is inverse: the greater the propensity, the lower the rate, and conversely.

When the spinner delivers yarn to the weaver and is offered payment in the form of a bill drawn on the fabric merchant, he will accept it but will apply a discount to the face value. The question is how the two tradesmen can come to an agreement what rate to apply. There can be only one answer to this question: a
lower discount rate will be acceptable to the spinner if the market is brisk; however, a higher discount rate will be insisted on if the market is lethargic. Thus the discount rate is determined by the condition of the consumer goods market, and not by the availability of savings. It reflects the propensity to consume (with apologies to Keynes). There is no loan involved in discounting, so the rate of interest is irrelevant. Tradesmen processing semi-finished goods hardly ever pay cash for supplies to their suppliers. The prices they are quoted are not cash prices. They are “90 days net”. The credit is part of the deal: you need not even ask for it. On the rare occasion when you don’t need the credit you pre-pay your bill, having applied the discount to its face value.

Calendar of events

Come to Munich, the capital of Bavaria, for the next ten-day course of the New Austrian School of Economics, from August 20-29, 2011, where I shall answer any questions you may have on the origin of money, origin of interest, hoardability of monetary metals, opening the Mint to silver. Also on hand will be Sandeep Jaitly to tell you about the gold mine of the silver basis, and about the last contango in Washington. For details, consult: nasoe@kt-solutions.de
See also my website: www.professorfekete.com

July 4, 2011.