Lecture 11:

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GOLD STANDARD UNIVERSITY

Summer Semester

Monetary Economics 101: The Real Bills Doctrine of Adam Smith

Lecture 11

THE ACCEPTANCE HOUSE

- Illicit Interest Arbitrage -

**- The Second Greatest Story Ever Told,
Chapters 10 -11 -**

- The Discount Rate/Interest Rate Spread -

- Borrowing Short to Lend Long -

- Anticipation and Accommodation Bills -

Illicit Interest Arbitage

There was nothing sinister about the appearance of the Discount House, as a precursor of the bank. Nor was there anything suspicious about the bill of the goldsmith, as a precursor of the bank note. Fraud came later, as the story of the bill of exchange unfolded, and illicit interest arbitrage and the practice of borrowing short to lend long appeared and spread.

The villain of the piece is the Acceptance House, as we shall see, another (and this time quite sinister) precursor of the bank. The Acceptance House conspired with impostors in order to put fictitious bills of exchange into circulation. As long as these fictitious bills remained in the public domain, with due diligence, the fraud could be exposed. But soon enough some banks joined the conspiracy and started sheltering the fictitious bills in their portfolio of assets. For the Acceptance House and the conspiring banks this was a lucrative business. It allowed them to pocket the spread between the higher interest rate and the lower discount rate, to which they were not entitled. They wanted to profit but without taking risks. Not only did they take no risks, neither did they provide a service to society that might have justified the profit. The business of selling fictitious bills against buying bonds is called illicit interest arbitrage. It means borrowing funds in the bill market at the lower discount rate and peddle them in the bond market at the higher interest rate. The arbitrage is illicit, as we shall see it in full details later. It is a case of extortion. It is fraudulent as it involves misrepresentation and non-disclosure. The scheme of illicit interest arbitrage would collapse if transparence of business transaction were maintained and safeguarded. Now I return to *The Second Greatest Story Ever Told.*

Chapter Ten
in which the gentle reader learns why the miller and the baker were blacklisted at the Discount House

One day the manager of the Discount House noticed that a bid/asked spread appeared in the trading of the miller-on-baker bills. Buyers consistently bid a lower price than that asked by the sellers of these bills. Normally, there was no spread in bill trading. A bill with two good signatures could be bought and sold back-to-back, often at the same price. This is explained by the fact that the bill was an appreciating asset. Its value increased daily as the date of maturity approached. A bid/asked spread, whenever it appeared, suggested trouble. It indicated that there were too many of that particular bill around, discouraging buyers.

The manager of the Discount House suspended the trading of the miller-on-baker bills, waiting for the situation to clear itself. Soon it turned out that the miller had conspired with the baker in putting bills into circulation supposedly representing flour on the move to the bread-consuming public. In fact, however, there was no flour and there was no movement. There was only grain sitting in the miller's bins, held back by the miller in hope for an increase in the grain price. The miller and the baker were speculating that the poor harvest could create a shortage causing higher prices in the grain market, from which they wanted to benefit. They were trying to

finance their speculation by drawing miller-on-baker bills representing the grain withheld from consumption, sitting in the miller's bins.

The speculation ended in a fiasco. The miller's and baker's expectation of much higher grain prices didn't materialize. They 'rolled over' their credit, that is, they paid the maturing bill by drawing another on the same grain holdings. This was a very serious violation of the statutes of the bill market, because the limitation of 91 days on the maturity of bills was absolute. Under no circumstances must the bill on the same goods be redrawn.

In the meantime, the bill market grew less accommodating. As the fraudulent miller-on-baker bills were in addition to the regular ones supporting the supply of the consumer with bread (that is, on merchandise that did indeed move) a bid/asked spread appeared. When the Discount House suspended trading the miller-on-baker bills, the conspirators were squeezed. In order to extricate themselves from their situation they threw their grain on the market. The forced sale of such an abnormal quantity of grain temporarily depressed the price. The conspirators wound up their ill-fated speculation with a huge loss. In the end, they defaulted on some of their bills at maturity.

Default by merchants on their bills was exceedingly rare. Even loss of cargo at sea was no occasion for default. A bill drawn on merchandise in the bottom of vessels had to be accompanied by insurance certificates showing that the merchandise at sea had been insured to the extent of the full face value of the bill. In case of loss at sea the insurer would pay the bill at maturity.

If a merchant defaulted for reasons of personal financial tangles, then he could never again hope to discount a bill in his life. Nor could his sons. Their name was to remain on the blacklist for several generations. Being cut off from the bill market meant that the lifeline of the merchant was severed, as it were, his trading capital was confiscated. The merchant found himself out of business. This was exactly the fate awaiting the miller and his accomplice, the baker.

Speculation in Agricultural Commodities

It is important to understand that there is nothing wrong *per se* with speculating in agricultural commodities. As long as the speculator is using his own funds, or legitimately borrowed money for this purpose, no one has the right to criticize him. But the miller and the baker in our story tried to use the bill market for the purpose of financing speculative stores. This is definitely wrong. The bill market is strictly for merchandise that moves, moreover, move it must fast enough to reach the cash-paying

consumer in less than 91 days. It is fraudulent to represent that the merchandise held back for speculative purposes moves since, in fact, its movement has just been arrested.

Most tradesmen are sensible people realizing that, while speculation in agricultural commodities is a legitimate business, it must be financed properly. *The speculator has no right to shift his risks onto the shoulder of society.* For this is exactly what is involved in drawing bills on merchandise sitting in speculative stores waiting for a price-rise. The bill market, as we well-know, is a *clearing system*. It can only work if each bill faithfully represents the underlying transaction, and if the merchandise is moving as specified on the face of the bill. Accordingly, each bill is scrutinized by the market not only in regards of the credit standing of the drawer and the acceptor, and every subsequent endorser, but also in regards of the transaction represented on its face. Dubious bills, or bills which appear to be over-abundant, are rejected.

The miller and the baker did not try to defraud any particular individual. In drawing bills under false pretenses they tried to defraud the general public. They pretended that the underlying merchandise was moving and would reach the ultimate consumer in 91 days when, in fact, they were responsible for arresting the flow of goods. In doing so they were not merely hoping for speculative profits. They were also trying to shift the risks from their shoulders to the public at large. They wanted to pocket the difference between the higher interest rate and the lower discount rate. They would justify this as profits for shouldering risks. But they passed their risks on to the public. It is clear that they were not entitled to those profits.

The conspiracy of the miller and baker is an example of what we shall call illicit interest arbitrage. More generally, the term refers to arbitrage from the bill to the bond market. As interest rates are generally higher than the discount rate, the temptation is constantly present for tradesmen with ready access to the bill market to use bills for illegitimate purposes, such as selling them to invest the proceeds in bonds. Illicit interest arbitrage is a crime against the general public, the same as the crime of forging public documents. Indeed, the bill of exchange is a public document, and false statements on its face must be treated as fraud. (Note that arbitrage in the opposite direction, from the bond to the bill market is not illegitimate. Such action is profitable in the rare and abnormal case when interest rates are pushed below the discount rate. For this reason, it is called 'natural interest arbitrage'.)

The market tends to expose illicit interest arbitrage, as it exposed the conspiracy of the miller and the baker. But in so far as the conspiracy remains unexposed, the public at large is victimized in the form of higher prices.

Anticipation Bills

Chapter Eleven

in which the gentle reader learns how the miller and the baker went on the warpath to strike back by establishing the Acceptance House.

Many years have gone by, but they couldn't remove the bitterness of the miller and the baker over their humiliating failure. They felt that in being blacklisted at the Discount House they have been unjustly victimized. They thought that they were the 'misunderstood innovators'. They were plotting to take a revenge. Their opportunity came when the manager of the Discount House died, leaving his business to the elder of his two sons. The other son, known by the nickname Prodigal, did not inherit any part of his father's business nor, apparently, his acumen and integrity. The miller and the baker moved to befriend him.

"Your inheritance is more valuable than you realize, if you had eyes to see your fortune", the baker said to Prodigal. "Your name is spelled in gold. Let me show you how you can pan it. You should start a business of your own." But Prodigal pleaded poverty; he has already spent his patrimony. He could not put up the capital. "Never mind capital", retorted the miller. "We shall teach you a new creative way to start a business with no capital."

The young man may have been prodigal but he was not stupid. "Why don't you start your own business if you know how to do it without capital?" he asked. The baker explained, sotto voce, that you need a name with high recognition value to do that. Prodigal was the scion of a merchant family that has been in business for over two hundred years, the last fifty of which in discounting. It had an impeccable name and enjoyed the respect and admiration of everybody. "You contribute your name, and we contribute the expertise", the baker cajoled him. "You don't even have to work if you don't want to. We give you 50 percent of the profits. My friend, the miller and I will be satisfied with 25 percent each."

The offer was too good to turn it down. The 'enterprise' was called the Acceptance House. It would take business turned down at the Discount House. It would endorse - or to use the resurrected word, 'accept' - any bill presented to it, provided that two conditions were met. (1) The bill should have an air of demure respectability in referring to some goods about to be shipped. For this reason it was called an *anticipation bill*. (2) The face value of the bill should be posted as a collateral security in the form of mortgages on real estate or bonds. The Acceptance House was entitled to liquidate the collateral in case of a default by the drawer of the bill, but would return it upon payment of the bill in full at maturity. In addition, the Acceptance House stood ready to roll over the credit facility indefinitely upon advance mutual agreement.

Now the operators of the Acceptance House were in the position to bilk the general public out of its funds by taking advantage of the positive spread between the

interest and discount rates. In effect, they were selling bills and buying bonds with the proceeds, pocketing the difference, while taking no risk at all. At any rate, that's what they thought.

Accommodation Bills

The essence of the bill of exchange is that salable goods are moving to a place where there is a ready demand and market for them. The reason for making it payable at a later date is to allow for shipping and ultimate disposal, including the time needed for garnering the proceeds of the sale. The act of acceptance makes the bill of exchange immediately negotiable or convertible into cash through discounting. The bill had the advantage of 'paying itself'. The goods on which the bill was drawn, being certain of a market, are the guarantee to the bill's holder that "he is not holding the bag" containing nothing. The anticipation bill, promoted by the Acceptance House, was very different. The underlying goods did not move, and there was only a vague understanding that they eventually might. The sale of merchandise to the ultimate cash-paying consumer by the maturity date could no longer be taken for granted. On the contrary: it was a foregone conclusion that the anticipation bill would have to be redrawn and redrawn again, at the end of each 91-day period. That redrawing bills was a dubious practice was already pointed out by Adam Smith. Even worse was the practice of drawing accommodation bills. These were bills drawn on fictitious goods shipped to fictitious vendors. But the impeccable name of the Acceptance House made them as good as cash, regardless of the fraud involved in drawing them.

Debauching Accounting Standards

Banking has grown out of two separate roots: the business of the goldsmith, and that of the Acceptance House. The latter is the bad guy. Here is a conspiracy between the borrower and the Acceptance House with ready access to the bill market. Once the fraudulent anticipation and accommodation bills are removed from the bill markets and given shelter in the portfolio of the bank, then whatever possibility for the detection of the fraud had existed before was lost. The practice of shortchanging the public could be perpetuated.

The banks could create something out of nothing only through the fraud of accepting anticipation and accommodation, disregarding the fact that these bills were no longer self-liquidating. The banks could not care less how the borrowers would eventually get

the money to repay the loan. In case of a default the bank would liquidate the collateral and satisfy itself from the proceeds.

The banks were in fact usurping and monopolizing social circulating capital. They could get away with it by virtue of the government patent exempting banks from the rigors of bank examinations and from the strict application of accounting standards. The banks could carry their assets at arbitrary values. They said it was their business and nobody else's.

Before the government exempted the banks from the provisions of contract law, strict accounting standards had been in force reflecting the desire to protect the public from the consequences of conspiracy such as (1) declaring bankruptcy fraudulently (by representing assets at artificially low values) or, its more common counterpart, (2) window-dressing the balance sheet fraudulently in an effort to stave off a run on the bank (by representing assets at artificially *high* values). Honest accounting demands that the bank carry assets either at historical cost or at market value, *whichever is lower.* The government patent protecting the banks has resulted in permitting the banks to carry assets either historical cost or at market value, *whichever is higher.* Non-disclosure or misrepresentation of the true state of affairs is, of course, a crime against the public interest. But the banks were protected against prosecution by the patent the government has given them.

The profession of chartered accountants and bank examiners ought to stand guard over the integrity of balance sheets and the quality of assets of the banking industry. But it has long since departed from this ideal. Accounting codes and norms have been changed in order to suit the interest of the government, as opposed to the interest of the public. The government has become an accomplice in the fraud and a party to the conspiracy against the public. The government, in betraying its sacred mission of standing guard over the public interest, is motivated by its consuming passion to have its own debt monetized through the banking system.

Neither the government, nor the banks, nor the accounting profession will be able to escape responsibility for compromising accounting standards and for corrupting the profession of accountants and bank examiners, when the day of reckoning finally dawns. The present exercise of a witch-hunt to charge producers with accounting crimes is hypocritical in the extreme. The government should come clean of its own accounting crimes first.

The Two Categories of Bank Assets

Illicit interest arbitrage in modern setting manifests itself through certain practices of commercial banks. Economists have failed to make a distinction between bank assets

representing goods *on offer for sale* and others representing goods *not on offer for sale* in the markets. This distinction between the two types of bank assets is fundamental. The value of those of the first category is faithfully reflected in the balance sheet, as the market is continuously testing these values against existing and changing marginal utilities. In case of any discrepancy, correction is instantaneous and automatic. The same, however, is not true of assets of the second category. Here the balance sheet notoriously *overstates* values. These assets are sheltered from the trials and tribulations of the market place. They are protected against wear and tear due to the ravages of declining marginal utility, brought about by repeated market test.

For example, a house that is being built for the housing market by the contractor is on offer for sale, and a bridge-loan against it is a bank asset of the first category. By contrast, a home equity loan is a bank asset representing an item, your home, which is not on offer for sale (you hope) and, therefore, it is a bank asset of the second category. The seeds of a credit collapse are sowed by the banks themselves in loading their portfolio with assets of the second category. When the crunch comes, these assets are thrown on the market simultaneously and indiscriminately as the banks scramble to regain solvency. The market, which follows the law of declining marginal utility (rather than the wishful thinking of over-confident bankers) refuses to validate the fancy values at which these assets are carried in the balance sheet. The day of reckoning has dawned. The banks are confronted with the truth, and they are forced to absorb huge losses.

The practice of carrying assets of the second category is just another instance of illicit interest arbitrage. Once the banks usurp control over social circulating capital, they can borrow at the lower discount rate and peddle these funds at the higher interest rate to their clients. They can make this practice look legitimate with the connivance of the bank inspector who is trained to "hear no evil, see no evil, say no evil". But this activity cannot go on forever. Depositors who can read balance sheets will move their business from the illiquid bank (indulging in illicit interest arbitrage to a greater extent) to a more liquid bank (indulging in the practice to a lesser extent). The depositors' arbitrage (known in banking circles as 'disintermediation') will squeeze the illiquid banks. The liquidation that follows spawns the boom-bust cycle. It may take down sound businesses along with the shaky ones into bankruptcy. This reveals the most evil aspect of illicit interest arbitrage. Along with the guilty, the innocent is also made to suffer.

The key to preventing the boom-bust cycle is not to allow banks to carry assets of the second category in excess of capital accounts. Bank assets of the first category include gold (as all gold above ground is deemed to be on offer for sale under a gold standard) as well as bills of exchange drawn on goods that will be sold to the ultimate cash-paying consumer in less than 91 days. *These bills are the most liquid earning assets that a bank can have*. By contrast, assets in the second category are not liquid. They include stocks, bonds, mortgages, finance and treasury bills, or loans collateralized by these. Unlike self-liquidating bills, they are all subject to great fluctuations in value. In case of forced liquidation (for example, when a number of illiquid banks are scrambling to get liquid) all bids for them may be withdrawn, creating a panic.

But if all banks limited their portfolio to assets of the first category, then no runs and panics could occur. Even unusually large cash-withdrawals could be met without forced liquidation of assets. As one bank experiences cash-withdrawals, another with surplus cash will be eager to buy the bills of the former. At any rate, more than one-ninetieth of all banking assets backing sight liabilities is maturing every day, obviating the need for asset-liquidations. If the cash-shortage was brought about events outside of the control of the banks, such as natural disasters (e.g., crop failure, flood or earthquake destroying property), then the banks can adjust smoothly to the changing circumstances by discounting fewer bills during the construction period. It is virtually impossible that all bids for bank assets of the first category be withdrawn simultaneously. Shortage of cash here always results in a surplus of cash somewhere else. The latter will then start scrambling for liquid earning assets such as bills of exchange.

Crime and Punishment

This is a world of crime and punishment. The crime of illicit interest arbitrage cannot avoid receiving its just punishment eventually. It makes the positive spread between the interest and the discount rate vanish. This undermines not just the lucrative monopoly of the banks, but also the entire financial system. When the discount rate catches up with and surpasses the rate of interest, panic in the credit market will ensue. Bids for bonds are withdrawn. Bond prices will collapse, and the rate of interest will shoot up. This will render much of the productive capital of the country sub-marginal, causing depression.

Earlier I have quoted an old saying on Lombard Street that the easiest business in the world is banking, provided that the banker can grasp the difference between a bill of exchange and a mortgage. If bankers occasionally flunked this test in the 18th and 19th century, bankers in the 20th did not even understand what the fuss is all about. They shrug off the criticism. An asset is an asset is an asset... Money doesn't stink. It has no quality outside of its quantity. Ghosts that used to haunt bankers in their sleep, such as assets of dubious quality in the balance sheet, have been interned for good, thanks to government-administered safety nets.

However, it is doubtful that governments can legislate business risks and asset quality out of existence. The qualitative difference between a genuine bill of exchange and a mortgage cannot be denied (securitization of the latter notwithstanding). The former is easily negotiable before maturity without bribe or blackmail. At maturity it is cash by the sale of goods on which it is drawn. No safety net and no coercion is needed to promote its circulation. The latter is by no means readily negotiable. Mortgages or loans on real estate require two expensive and time-consuming processes: surveying and title search, before they can be transferred. Moreover, the real estate market, just as the bond market, could get demoralized as a result of the withdrawal of bids. The market in self-liquidating bills could never seize up the same way.

The quality of an asset cannot be improved by burying it deep inside of a bank's balance sheet. Non-disclosure and misrepresentation can only damage assets. For this reason, illicit interest arbitrage is even more dangerous when practiced by banks. The conspiracy in which the Acceptance House engaged was bad enough, but at least the dubious assets stayed in the public view. The bill market was still a level playing field, and the Discount House was still acting as an umpire, blowing the whistle whenever fair play was put in jeopardy. There was a feed-back which prompted self-correction, in so far as the quality of credit was concerned. No more. Commercial banks have removed the dubious assets from public view, sheltering them in their balance sheet. The public is no longer in the position to scrutinize those assets, and is powerless to prevent further deterioration in the quality of credit. Bank assets are diluted, and the self-correcting mechanism of the credit market is short-circuited. The effect is a cumulative deterioration of bank credit. When credit collapse finally comes, it will be all the more devastating. Recovery will be more painful and take longer.

* * *

Small Is Beautiful after All?

Don Lloyd of Peabody, Michigan, comments on Mises' position on bank notes of small denomination (re: Lecture 9, "Small Is Ugly"). He disputes that there is a misprint on p 494 of *The Theory of Money and Credit* where Mises calls for the issuance of bank notes in denominations of one dollar, fifty dollars, and upwards. In other words, Mises thought it was admissible to issue bank notes of small denomination, in spite of objections of English authors finding the issuance of small bank notes detrimental to the interest of the working classes.

My own interpretation is that Mises was convinced that in the interest of the preservation of the gold coin standard he was advocating, and for the protection of the working people who would be cheated out of their possession of gold coins by small bank notes, the issuance of such notes should not be authorized. However, if Mises really meant that one dollar bank notes be circulated under the new gold coin standard he was describing, then he would appear to be condoning the practice of withholding gold coins from the working classes. I would regret it if it was true. At any rate, I think more research into the question of Mises' attitude with reference to bank notes of small denomination should be carried out to clarify this point.

Money and Morality

One of the recurring themes of this lecture series is money and morality. Therefore it was very rewarding for me to receive the following message from Carl Luxem, Jr .

Dear Professor:

I have been reading your lectures at Gold-Eagle.com. They bring to mind something one of my mentors told me years ago, namely, that "God designed life so that it does not work without Him, nor without the order He established for it". Given how far the world has departed from the economic order you are describing, I expect the coming reality shock to be quite devastating. Your attempts to warn and educate us about the evil inherent in the present system are admirable. I have tried to do the same with some success by viewing the problem from a moral perspective. I deeply appreciate your work because, as a money manager and a student of economics, it has been a long time since I have been able to find anything that makes as much sense as your lectures.

Sincerely, etc.

Carl, I think we are getting through. Just keep up the good fight.

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GOLD STANDARD UNIVERSITY

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Monetary Economics 101: The Real Bills Doctrine of Adam Smith

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