Lecture 12:

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GOLD STANDARD UNIVERSITY

Summer Semester

Monetary Economics 101: The Real Bills Doctrine of Adam Smith

Lecture 12

BORROWING SHORT TO LEND LONG

- The Second Greatest Story Ever Told, Chapter 12 -

- The Interest/Discount Spread -

- Non-Disclosure, Misrepresentation, Lack of Transparency -

- Self-Liquidating Loans -

- In Praise of Scholasticism -

Chapter 12

in which the gentle reader learns why the miller and the baker did not succeed to commit the perfect crime

Having burnt their fingers once before, the miller and the baker proceeded very cautiously. They understood very well the inherent danger that the bill market may reject their anticipation and accommodation bills. Therefore they insisted that their customers post collateral security.

"We can now print our own money" gloated the miller. "When we accept accommodation bills, we borrow at the lower discount rate in order to lend at the higher interest rate. We simply pocket the difference between the two. It's manna from heaven." The baker added gleefully: "And if our customers fall upon hard times and can't pay their debt, no harm done. We shall pay on their behalf out of the proceeds of their collateral."

The miller and the baker went on creating bills merely for the sake of discounting them, and so to provide their customers with ready cash, and themselves with an income. In order to make these accommodation bills more attractive to the prospective buyer, they invented goods and sent them on imaginary trips around the globe. They thought that chances of exposure of the fraud were nil. They would never ever allow their customers to default. Should they be unable to pay, the Acceptance House would routinely pay off their debt at maturity without demur, and get compensated by selling the collateral. Whenever the market value of the collateral fell, the Acceptance House would issue a 'margin call', that is, a call to restore market value to the original level by posting more collateral.

For a time it looked as if the baker and the miller have indeed succeeded in inventing the 'perfect fraud'. The sky was the limit to the profits to be made in the acceptance business, as only human imagination could limit the type of goods to be invented for the purpose of discounting. Alas, there was a fly in the ointment. What the baker and the miller forgot to consider was that their profit depended on a positive spread between the interest rate and the discount rate. But their activities were undermining exactly this foundation. As more and more fictitious bills were put into circulation, the spread narrowed. The Acceptance House was forced to accept ever more fictitious bills in order to maintain its customary profit margin. This, of course, made the spread to narrow further. Clients were caught up in the squeeze and were forced to forfeit their collateral. The burden of the fraud was shifted to the mortgage market and, ultimately, to the real estate market.

One day the miller came home with bad news: "You can buy real estate as cheap as stinking mackerel", he said to the baker. "We had better liquidate all the mortgages in our portfolio before the owners walk away from their properties." But it was too

late. There were no more takers for first mortgage on prime commercial real estate than for a third mortgage on a farm in the moon.

The Acceptance House, too, was forced into liquidation. The conspiracy of the miller and the baker collapsed once more. The worst aspect of the disaster was that it victimized a lot of innocent bystanders, owners of real estate who had nothing to do with the fraud and the conspiracy, but who nevertheless suffered real losses because of it.

It is clear that accepting anticipation or accommodation bills amounts to illicit interest arbitrage. The drawers of these bills should properly go to the bond (i.e., loan) market and borrow at the prevailing rate of interest, making full disclosure to the lenders about the nature of their enterprise. Instead, they went to the Acceptance House where full disclosure was not a requirement. In this way they could keep their cards closer to their chest and escape scrutiny as to the nature of their business, as well as control that lenders would normally want to exercise over the activities of their borrowers. For its part, the Acceptance House welcomed this business because of its great profitability. It pocketed the spread between the rate of interest and the discount rate without assuming any risk, indeed, without rendering any useful service to society (such as the Discount House does).

Borrowing Short to Lend Long

More generally, it is illegitimate to borrow short in order to lend long. To do so is tantamount to making unwarranted assumptions about future market and credit conditions. There is no way to predict what the consumer will demand most urgently in the future, nor to predict what items will fall out of his favor. There is no way to predict how tight credit conditions will be.

There are those ‘free market economists’ who call the denunciation of borrowing short to lend long a witch-hunt. They say that the practice cannot be condemned on economic grounds, any more than risk-taking can. "Let competition prevail", they argue, "and let the smartest guy win the jackpot!" They call our criticism, at best, a moral judgment; at worst, an effort to stifle competition. It is not for the economist to make moral judgments on what is and what is not an acceptable level of risk-taking.

There is no need to quarrel with the last statement. But to say that the case against borrowing short to lend long has nothing to do with economics shows a profound lack of understanding of the market process. It should be clear that the dispute is not about risk-taking. The proposition that borrowing short to lend long ought to be outlawed does not aim at stifling competition, any more than the proposition that misrepresenting the quantity or quality of goods offered for sale ought to be outlawed does. Economics does not criticize speculation and other forms of risk-taking as long as risk-takers use their own funds, or they persuaded someone else to advance funds for this purpose.

Social circulating capital is not owned by any individual, nor by any group of individuals. It is communal property, as it were. It is property 'socialized' in the best sense of the word. The flip-side of social circulating capital is the bill market. To dip into the bill market in order to raise funds without contributing anything in return is the same as stealing communal property. Just what is a valid contribution to social circulating capital and what isn't, is a question that is decided by the bill market. If the bill, making full disclosure without misrepresentation, can be discounted at the going rate, then the underlying good belongs to the social circulating capital; otherwise it doesn't. Bills that can be so discounted are capable of monetary circulation; others aren't. This is an objective criterion setting apart self-liquidating bills from anticipation, accommodation, and other fiduciary bills. There is no appeal against the verdict of the market. There is no scientific argument that could overrule it. We may assume that according to the most authoritative scientific research "miracle product *X*" ought to have a place in everybody's household. But, unless this opinion can convince consumers, product *X* will not be part of the social circulating capital, and bills drawn against it just won't circulate. The bill market is the final arbiter on that matter. However, all statements on the face of the bill must be true to fact and to intention. Otherwise the bill is disqualified and becomes phony, and the drawer and acceptor become impostors and counterfeiters. They should be subject to the same punishment reserved for the conspirators in coin-clipping and forgery of bank notes.

Baring Brothers

The textbook example of the fate of the Acceptance House guilty of illicit interest arbitrage is the collapse of the House of Baring in 1890. The firm Baring Brothers & Co. was established in 1763 in London by John and Francis Baring. They were the sons of John Baring (1697-1748), a successful German cloth manufacturer who in 1717 started a small business in Devon. At first the partners were import and export commission agents for other merchants, but they soon began to lend their credit in the form of trade acceptances. They were involved in financing the British war effort against revolutionary France and, later, that of the Union against the Confederacy in North America. In 1890 the firm was still controlled by the Baring family when it got involved in Argentinean and Russian government finances and collapsed. Baring Brothers & Co. was bailed out by the Bank of England. However, as an Acceptance House, the firm's credit was effectively ruined. See *The House of Baring* by R.W. Hidy published in 1949.

The Interest/Discount Spread

If the market knowingly discounted undisguised anticipation and accommodation bills at the same discount rate as that applicable to real bills, then there would be no basis for objecting against these fiduciary bills. But clearly this is not the case. Undisguised accommodation bills would never circulate. Disguised accommodation bills may circulate for a time, thanks to the conspiracy of the Acceptance House and its clients but, as a rule, the fraud will come to light sooner or later. The charge of non-disclosure, fraud, and misrepresentation concerning the nature and the status of goods on the face of the bill stands.

The positive spread between the interest and the discount rate is not there for the picking. It is there to support social circulating capital. Supplying the consumer with urgently needed goods on the shortest possible notice and in the most efficient manner would become prohibitively expensive, were it not for the presence of the spread. Bread and milk would have to be supplied on the same harsh terms as the surgeon’s knife and the watchmaker’s precision instruments. The publisher of newspapers would have to apply the same mark-up as that of a Sanskrit grammar. Indeed, milk, bread, and newspapers are perishable. Incentives to produce and distribute them for the benefit of society are absolutely essential. Of course, we don’t mean subsidies. We mean the spontaneous incentive embodied in the undistorted spread between the interest and discount rates.

Damages caused by natural disasters, for example, would be far harder to heal (and, hence, far more devastating) in the absence of a positive spread. The productive apparatus of society would be less efficient, more wasteful, and less responsive to changes in the absence of a positive spread between the interest and discount rates. It should be evident that the market needs safeguards against illicit interest arbitrage causing the spread to vanish, much the same as it needs safeguards to prevent any other form of fraud. Alas, it was not done in the heyday of bill-trading and of the gold standard, before the outbreak of World War I. llicit interest arbitrage should have been outlawed, and fraud in bill-drawing punished. It should have been enshrined in legislation governing the bill market that drawing anticipation and accommodation bills is tantamount to falsifying public documents and, as such, constituted fraud. This would have put the Discount House in a stronger position to detect and expose fraudulent bills. The Acceptance House could no longer safely accept bills known to carry false statements on their face. This is not just a legal and moral problem. It is also one of economics. It is most unfortunate that the economists’ profession contributed nothing to its solution. It took the ‘see no evil, hear no evil’ attitude, leaving the problem to solve itself ‘through competition’. It ignored the fact that fraud lends an unfair advantage to its practitioners, and it was futile to expect that competition could purge business of crooked practices.

The position of the Austrian School, inspired by Mises, suggests that credit expansion by the banks (which we could identify with the acceptance of anticipation and accommodation bills) would be forestalled by the institution of 'free banking': the best-managed banks would survive. It is a strange way to handle fraud in letting competition take care of it. The Austrian School must recognize the presence of fraud in credit expansion. The reason that it has failed to do so is its superstitious adherence to the Quantity Theory of Money, and its mindless rejection of the Real Bills Doctrine of Adam Smith.

Non-Disclosure, Misrepresentation, and Lack of Transparency

We should realize that the problem has become worse, exposure of the conspiracy made more difficult, and the watershed between upright and fraudulent business conduct further obscured when the banks started emulating practices of the Acceptance House. As we know, earlier the banks emulated the practices of the Discount House. So long as they confined their activities to discounting self-liquidating bills only (or lent against business transactions moving salable merchandise to the ultimate cash-paying consumer only), they were merely supplementing the efforts of the Discount House, and no fraud would be involved. Fraud appeared when they started emulating the Acceptance House.

The banks, no less than the Discount House, cannot create credit. They negotiate it. The credit already exists by virtue of the underlying merchandise moving apace to the ultimate cash-paying consumer. In discounting only self-liquidating bills, or in lending only against such collateral, the banks merely make the credit more convenient and more negotiable. This is legitimate business, it is a healthy form of using credit. The Austrian School is mistaken in bundling it together with other forms of credit expansion causing economic harm, such as discounting anticipation, accommodation, and any other types of fiduciary bills, or in lending against such collateral, emulating the harmful practices of the Acceptance House. In doing so the banks practice illicit interest arbitrage. No longer are they engaged in legitimate business, but in a form of credit-abuse. Just like the Acceptance House, the banks fraudulently raise funds in the bill market at the discount rate and peddle them in the bond market at the rate of interest. In the process they appropriate the spread between the higher interest rate and the lower discount rate, to which they they are not entitled.

Notice non-disclosure, misrepresentation, and lack of transparency in the banks' procedure. The fraudulently drafted paper and other dubious or illiquid assets are now sheltered in the banks' portfolio. They are no longer available for public examination, as they have been earlier when the Acceptance House was trading them in the bill market. It is true that bank examiners could scrutinize these assets but, to the extent that they are paid by the government, they will follow norms adopted by their paymaster. It is clear that government wants to classify Treasury bills as paper eligible for discounting, or to be used for collateralizing loans. Therefore the stage is set for subverting the system of bank inspection. The problem of money and credit is thereby reduced to that of non-disclosure, misrepresentation of banking assets, and lack of transparency. The fictitious bills are withdrawn from circulation where they could be recognized and rejected by the public, and buried in the bank's portfolio where they could not. Exposure of fraud and conspiracy has become more difficult, and illicit interest arbitrage harder to detect.

This raises questions of responsibility. Accounting standards and the agenda for bank examiners are set by the government. Inclined to favor a minority at the expense of the majority, the government has succumbed to the temptation, allowed compromising accounting standard and covering up fraud and conspiracy. Moreover, the government has embarked upon the path of promoting its own Treasury Bills as money. This is the worst kind of government incursion in the banking business, short of nationalizing it. The practice of the government furnishing illiquid assets for bank portfolios, while maintaining the pretense of liquidity, has been greatly expanded in the twentieth century, and is now more wide-spread than ever. It is further reinforced by distorting the theory of banking. The government is charged with the task of managing the nation's economy as well as its money supply. By allowing its debt to be used for the purposes of monetization by the banks, the government has appointed itself as dictator of the economy. It can order economic participants to obey its orders, punishing those who resist, with the carrot of the money supply and the stick of high taxation.

Another way of describing what has happened is this. By overtaking the bill market, the banks have hijacked the social circulating capital. They have put all the producers and distributors as well as a large part of the consuming public permanently in debt to themselves. We may recall that the social circulating capital used to possess a great momentum of its own, so that lending could be replaced by clearing. The banking fraternity, under leave from the government, has reversed this. The spontaneity of bill circulation has now been replaced by the duress of bank lending. In other words the banks, through their control of the social circulating capital, hold society to ransom.

Self-Liquidating Loans

According to Ludwig von Mises all the note and deposit liabilities of the banks in excess of capital accounts and vault cash are inflationary and contribute to credit expansion. They tend to suppress the rate of interest below the level that would obtain in the absence of bank lending. Mises does not recognize the idea of self-liquidating loans that finance the movement of merchandise and are to be repaid in 91 days or less from the proceeds of the sale of that merchandise to the ultimate cash-paying consumer. Nor does he recognize the essential difference between the interest rate and the discount rate. Yet these two rates are entirely independent of one another as their changes are autonomous. Either may be stationary while the other moves. If both move, they may move in the same or in the opposite direction. The very forces governing changes of either are different. The discount rate is governed by the propensity to consume, while the rate of interest is governed by the propensity to save. As other quantity theorists, Mises holds that lower propensity to consume necessarily means higher propensity to save. Yet this is a palpably false proposition: it is possible that people decide to withhold gold from both the bill and bond markets. The only connection between the two rates is that the discount rate is not supposed to rise above the rate of interest. It is true that illicit interest arbitrage may drive the discount rate above the rate of interest temporarily. It will take a separate course of this University to investigate the consequences of this. We refer to the great topic of the business cycle.

Short-term self-liquidating loans by the banks are loans in form only. In substance they are instances of clearing, in exactly the same way as bills of exchange are. In effect, the bank discounts bills of the producers and distributors. The resulting ‘loans’ are definitely non-inflationary. The reason is that those bills could in fact circulate on their own. The bank has to withdraw them from circulation (or to preempt them from entering circulation) when making a self-liquidating loan. There is no net increase in the volume of purchasing media. The underlying credit exists on its own merit. *It would exist even in the complete absence of banks*. To put this differently, self-liquidating loans represent not lending but clearing activity. Only by abuse of language can they be called loans. This is most unfortunate, as the functions of lending and clearing ought to be kept separate, and should under no circumstance be confused. Only then can one see that there is no increase in the volume of purchasing media as a result of the bank extending a self-liquidating loan. I repeat: the bank is not issuing credit; it is merely negotiating it. The credit already exists on the strength of the urgent demand for the underlying consumer good. The bank merely substitutes its own credit (which is more convenient and more negotiable, and recognized more widely) for the credit of the producers and distributors (which may be less convenient and less negotiable, and recognized less widely). Whether the credit is in the form of a bill of exchange, or in the form of a self-liquidating bank loan, its circulation simply mirrors that of the underlying merchandise in urgent demand.

Mises and the Social Circulating Capital

Of course, not every consumer good is such that its movement can be financed by self-liquidating bank loans. Slow-moving merchandise, durable goods sold on installment plans as opposed to cash payments in full are some of the examples that don’t qualify. Such goods are no part of the social circulating capital, as Adam Smith characterized the mass of fast-moving goods on their way from the producers to the ultimate cash-paying consumers that will reach its destination in 91 days or sooner. Certain merchandise may at one point in time belong to the social circulating capital only to fall out of it later as a result of changing consumer tastes and habits. Other merchandise may regularly enter in and out of the social circulating capital following the seasons. Heating fuel and seasonal clothing are examples. This highlights the rationale for limiting the terms of self-liquidating loans to 91 days. Under no circumstances must the term for such loans be extended by the bank. Financing the movement of merchandise that may take longer than 91 days to reach the consumer is not the task of the commercial bank that 'lends' at the discount rate. It is the task of the investment bank that lends at the higher rate of interest.

Mises recognizes neither the bill of exchange nor the self-liquidating loan as a non-inflationary source of credit. Neither does he make a distinction between the discount and interest rates. Most glaring is the failure of Mises to accept the existence of social circulating capital. Although Mises often talks about the importance of urgent consumer demand and the significance of consumer's choice, he fails to draw the necessary consequence which is as follows. The most urgently demanded consumer goods are distinguished by the market in being given preferential treatment: their movement to the consumer need not be financed through lending. Items in the social circulating capital finance their own movement through clearing. It is indeed most unfortunate that Mises and other sound-money economists have failed to make the important distinction between self-liquidating loans of the commercial banks and other loans that investment banks may make. As a consequence of this failure they have to condemn all bank lending in excess of capital accounts and vault cash as inflationary, which is a grave error.

100 Percent Gold Reserve Banking

Some sound-money theorists such as Murray Rothbard see the solution to the problem of credit abuse in the so-called 100 percent gold reserve banking. They suggest that banks should maintain 100 percent gold reserves against all their outstanding credit. No bank is supposed to lend in excess of capital accounts and vault cash. However, this dogmatic approach throws the baby out with the bath water. The prescription has been made on the wrong diagnosis of the problem. The problem is not that banks lend against assets other than gold. The problem is that banks borrow short in order to lend long. In their lending practices banks make commitments not justified by the quality and maturity of the assets they hold. Advocates of 100 percent gold reserve banking are barking up on the wrong tree. They have missed the real culprit, illicit interest arbitrage. The problem of bank illiquidity is not going to be solved by the 100 percent gold reserve requirement, but by prescribing that banks discount eligible paper only. Consumer demand is seasonal as well as unpredictable. Accordingly, the supply of purchasing media must be elastic. It must flow and ebb with consumer demand. It must vary with the seasons. Without an elastic supply of purchasing media the distribution of consumer goods may seize up amidst plenty. In addition, one must also face the problem of financing the production and distribution of consumer goods most efficiently, and without hindering technological progress. This progress can be illustrated in terms of refinements in the division of labor. 100 percent gold reserve banking would imply that every new refinement must mean another invasion of the pool of circulating gold coins. Under these condition the gold standard would be a fetter upon technological progress.

Do Banks Create Credit out of Thin Air?

Banks do not create credit out of thin air, as suggested by Mises in his *Theory of Money and Credit* (op.cit., p 279, p 390). To the extent they restrict their portfolio to self-liquidating loans, they do not contribute to credit expansion. They merely make credit that already exists by virtue of the very movement of merchandise to the consumer more negotiable. This is certainly a legitimate activity of the banks. To the extent the banks lend against assets other than self-liquidating paper, they borrow short to lend long. They raise funds in the bill market to place them in the bond market. Alrhough this is an extremely lucrative business, it is illegitimate nevertheless. The banks pocket the spread between the higher interest rate and the lower discount rate to which they are not entitled: they make no contribution to the production process. In this case, no less than in the previous, bank credit is not created out of thin air. Borrowing short to lend long is no prestidigitation. *It is fraud*. It is fraudulent to arbitrage funds from the bill to the bond market. The way to see that the bank is guilty of illicit interest arbitrage is to examine the maturity dates in the bank's portfolio of assets, including the maturity of the collateral. If the bank is willing to extend the maturity of its loans beyond 91 days, or if it lends against assets that are not self-liquidating, or if it buys such assets for its own account, then the bank is engaging in illicit interest arbitrage. Through non-disclosure and misrepresentation these illicit transactions are disguised so that they can no longer be detected by the public. Illiquid assets are buried deep in the portfolio and start to metastasize in the banking system. No longer is there a limit to the size of bank assets. (In the absence of illicit interest arbitrage social circulating capital set the limit.) Now that the limit has been removed, the pressure is on for the banks to increase their assets in order to maintain profit-levels. One bank drops an innocuous snow ball on the mountain slope, unmindful of the danger that the size and momentum of the innocuous snow ball could increase rapidly, eventually destroying entire villages down below in the valley. The dropping of the snow ball is the beginning of the business cycle; the avalanche is the depression into which it may degenerate. As detection of credit abuse becomes harder, the business cycle started by the banks is even more devastating than that started by the Acceptance House.

Banks are guilty of usurping power over the social circulating capital. They are guilty of extortion: they pocket the spread between the rate of interest and the discount rate to which they are not entitled. The banks are guilty of conspiring against the public interest, just as the miller and the baker were in accepting anticipation and accommodation bills in the hope of illicit gains. The conspiracy of the banks is far more ominous: distortions and misallocations caused by the banks' illicit interest arbitrage are cumulative and potentially very damaging. Ultimately, they must lead to a credit collapse.

We must conclude that the banks are not creating credit out of thin air. It must be made clear for once and all that nobody can do that. The banks, aided and abetted by the government and its bank examiners, arbitrage funds from the bill to the bond market illegitimately. In doing so they are committing a serious crime against the public.

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Monetary Economics 101: The Real Bills Doctrine of Adam Smith

Lecture 1: Ayn Rand's Hymn to Money
Lecture 2: Don't Fix the Dollar Price of Gold
Lecture 3: Credit Unions

Lecture 4: The Two Sources of Credit
Lecture 5: The Second Greatest Story Ever Told, Chapters 1 - 3
Lecture 6: The Invention of Discounting, Chapters 4 - 6
Lecture 7: The Mystery of The Discount Rate, Chapters 7 - 8
Lecture 8: Bills of The Goldsmith, Chapter 9
Lecture 9: Legal Tender, Small Bank Notes
Lecture 10: The Revolt of Quality
Lecture 11: The Acceptance House, Chapters 10 - 11
Lecture 12: Borrowing Short to Lend Long, Chapter 12
Lecture 13: The Unadulterated Gold Standard, Chapter 13