**position papers of professorfekete #4, July 25, 2010.**

# REAL BILLS REVISITED

Adam Smith in his *Wealth of Nations* worked out the foundations of a second type of credit that is based, not on savings, but on consumption. Later this theory was pejoratively called "Real Bills Doctrine" by its detractors. We stick to this name because the adjective "real" admirably captures the essence of a bill of exchange, making it different from anticipation bills, accommodation bills, treasury bills, which all have a measure of being "unreal". What makes real bills real is that they represent real goods and real services in greatest demand without which society would stop functioning in a matter of months, if not weeks or days. Examples are: bread, seasonal clothes, fuel in winter; the services of the miller and the baker; the spinner and the weaver, etc. Seasonal goods will be removed from the market by the consumer during the next 91-day period, before the turn of seasons changes demand.

A real bill, as its name suggests, is just a notice of payment due that typically the wholesale merchant sends to the retail merchant along with his shipment of goods demanded most urgently by the consumers. It is useful to think of the bill as a security in the process of "maturing into the gold coin" that the consumer will expend when he buys the underlying good. The value of the real bill, unlike that of most securities, is increasing day-after-day till maturity, which is at most 91 days away. By that time the goods itemized on the bill will have been sold to the ultimate gold-paying consumer and disbursement of the proceeds is in progress. The face value of the bill is the amount to be paid upon maturity.

It is a grave error to think that the bill represents a loan transaction. The wholesaler *is not* lending and the retailer *is not* borrowing. The credit is an inseparable part of the transaction, as confirmed by centuries and centuries of merchant custom. The quoted price is never ever cash: it is "91 days net". The goods are more valuable and more liquid in the hands of the retailer than in the hands of the wholesaler by virtue of the former's greater proximity to the gold coin. Who is the wholesaler to extend a loan to the retailer?

The most important aspect of a real bill is its metamorphosis that takes place when the retail merchant endorses it by writing "I accept" across its face over his signature. At that moment the character of the real bill changes from that of a *notice* of payment due, to that of a *means* of payment. In fact, the bill is acceptable in payment by the trade. It is returned to the wholesale merchant who can now replenish his inventory and pay his supplier with the bill complete with his endorsement. This metamorphosis of the bill from a notice of payment to a means of payment is one of the few miracles that economics has to deal with. Economists have to explain the *circulation* of real bills, and the fact that other bills such as accommodation bills just won't circulate. Nor will mortgages.

This is certainly not a case of creating something out of nothing. Subsequent endorsements of the bill occur as the semi-finished good underlying the bill is passed on from the higher to the lower order producer. In each case the bill is subject to a discount, that is, the seller of semi-finished goods accepts the bill in payment subject to a reduction of face value proportional to the number of days remaining before maturity as well as to the prevailing *discount rate*.

It is a serious error to confuse the discount rate with the rate of interest. The two have different sources: the propensity to consume and the propensity to save. The discount rate varies inversely with the propensity to consume; the rate of interest varies inversely with the propensity to save.

The type of credit represented by the real bill is also called *self-liquidating* as all the obligations originating from the journey of the bill will be liquidated out of the proceeds of the final sale, that is, out of the gold coin surrendered by the ultimate consumer. Credits of other types are not self-liquidating. For example, a mortgage is not usually liquidated from the proceeds of the sale of

the underlying real estate; typically it is liquidated over a long period of time from other sources. It is important that in the case of a bill of exchange the credit is liquidated *simultaneously* with the sale of the underlying merchandise and, therefore, self-liquidating credit is never inflationary.

Self-liquidating credit is indispensable in paying laborers who produce the underlying goods, often as much as 91 days before the ultimate consumer purchases the product. In the meantime laborers must eat, get clad and shod. Thanks to self-liquidating credit, there is no problem in paying labor's worth long before the product is sold. The laborers' remuneration comes out of the proceeds from discounting the unexpired real bill. We express this dependence by saying: "*No bills, no wage fund*".

Evidently, real bills make sense only in the context of a gold standard. The system worked for a hundred years without a hitch. It would be preposterous to suggest that a real bill "matures" into an irredeemable bank note. All things considered, both the bill and the note are instruments of credit but, of the two, the first is vastly superior. How can a superior instrument mature into an inferior one? It is also evident that the bill market is the clearing house of the gold standard. Even under a gold standard not all payments are made in the form of gold coins. Only *balances* arising between mature bills at the clearing house are settled in gold upon the closing of every business day. The *vast majority* of payments are made, not in gold but by "crossing out" the value of bills of equal value. Without the bill market the gold standard is still-born. Removing the bill market is tantamount to castrating the gold standard, making it impotent. *Without bill circulation the gold standard will not perform*, as we shall now see.

Before 1914 world trade was financed through real bills drawn on London. Hostilities in World War I shut down the bill market. World trade became touch-and-go, strewn with shortages. After the armistice the Entente powers did not lift the economic blockade of Germany and other central powers but, in their wisdom, decided not to return to multilateral world trade at all. Instead, they kept international trade at the barter level what they called "bilateral trade". In this way they thought they could monitor and control Germany's imports and exports. They accepted the fact that this would also inconvenience their own producers and distributors, but for them it was a small price to pay for safety from German rearmament. They were blinded by hatred as they wanted to punish Germany over and above the provisions of the peace treaty. They forgot that the gold standard they reintroduced (the pound sterling was made gold-convertible in 1925) could not function without its clearing system, the bill market. The result was the vanishing of world trade, the Great Depression, the collapse of the gold standard and, most frightening, *the destruction of the wage fund causing catastrophic unemployment world-wide* — as correctly predicted by the German economist Heinrich Rittershausen.

The ban on international bill trading by the Entente was tantamount to the destruction of the wage fund. Producers of goods demanded most urgently by the consumers could no longer pay their laborers and laid them off. Governments were forced to pay out dole to the unemployed in order to contain social unrest. The gold standard did not fail because of its inner contradictions, as charged by Keynes. It failed because of sabotage by the Entente in blocking the international bill market, the clearing house of the gold standard.

Under the regime of irredeemable currency self-liquidating credit plays no role whatever. As a consequence, the Debt Tower of Babel can only grow until it will topple, burying the world economy under the rubble. It would be most unfortunate if the gold standard were rehabilitated without rehabilitating its clearing house, the international bill market. Only the latter can replenish the wage fund so that everybody eager to earn wages could find a job.

Arguments that real bills are inflationary are based on ignorance of facts, as well as on ignorance of the rich literature on self-liquidating credit.

If Paul Krugman of The New York Times *really* wanted to restore jobs to the unemployed, he would advocate the restoration of the gold standard and its clearing house, the international bill market.

## Calendar of Events

**ANNOUNCING THE ESTABLISHMENT OF THE AUSTRIAN SCHOOL OF ECONOMICS IN BUDAPEST. The first ten-day, 20-lecture course offered is entitled: Disorder and Coordination in Economics — *Has the world reached the ultimate economic and monetary disorder?*** The lecturer is Professor Fekete, with the cooperation of Mr. Rudy Fritsch (Canada), Peter van Coppenolle (Belgium), and Mr. Sandeep Jaitly (United Kingdom). It will be held in Budapest, Hungary, from August 9-20, 2010. Participation is limited, early registration is advisable. For more information and registration, contact Dr. Judith Szepesvari at: szepesvari17@gmail.com. Inexpensive dorm-type accommodation is available for students (shared bathroom, shared kitchen); a three-star hotel is next door. Extra-curricular consulting with Professor Fekete can be arranged for an extra fee.

The school is meant for all students (including beginners) interested in the real answers to the present economic crisis and misery. Its program plans to cover the whole spectrum of Austrian economics, with special emphasis on developments that took place after the death of the greatest 20th century economist, Ludwig von Mises, including the Real Bills doctrine and social circulating capital; the theory of money, credit and banking; and the theory of interest and discount.

Completion of this course will earn participants one credit towards a four-course, four-credit program that has been submitted for accreditation to the Adult Education Accreditation Board of Hungary. Participants will receive a certificate signed by Professor Fekete. The follow-up credit courses will cover these areas:

Adam Smith's Real Bills Doctrine and Social Circulating Capital.

The Austrian Theory of Interest and Discount.

The Austrian Theory of Money, Credit, and Banking.

Some of the future courses may be offered in Martineum Academy in Szombathely, Hungary, where we have had four successful conferences already in the past. A special cordial invitation is extended to all Martineum alumni and their family members and friends!

*Eating and shopping facilities, as well as a swimming pool are nearby. Spectacular excursions can be arranged in the surrounding hills, and boat trips on the River Danube.*

*It is well-known that Budapest is one of the foremost spas in Central Europe with a dozen or so medicinal thermal springs. Participants of the course could stay on afterwards and savor the superb spa and cultural offerings in the city. Make it a family holiday!*

## Meeting in Hong Kong

We have plans for a two-day meeting in Hong Kong and another neeting in New Zealand in November, 2010. Stay tuned for further announcements.