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"A REVISIONIST THEORY AND HISTORY OF MONEY"

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The purpose of this new series is to show that the Great Depression of the 1930's bringing unprecedented world-wide unemployment in its wake was not due to the "contractionist" nature of the gold standard as alleged by John M. Keynes. Nor was it due to "fractional reserve banking" as alleged by Murray Rothbard. Rather, it was due to *the national governments sabotaging the clearing system of the international gold standard, namely, the bill market.*

Adam Smith's Real Bills Doctrine reigned supreme in monetary science throughout the 19th century, and rightfully so. It explained how it was possible to refine division of labor in order to improve the efficiency of labor, and to lengthen production processes making them "more roundabout" in order to improve the efficiency of capital, without causing monetary contraction through unnecessarily invading the pool of circulating gold coins and tying up savings to finance circulating capital. If the goods were demanded urgently enough by the consumer, then circulating capital would be readily available without raiding cookie jars for savings. The written document billing the producer of lower-order goods by the producer of higher-order goods for supplies shipped, when endorsed by the former, would become a means of payment in the hand of the latter. Indeed, bills of exchange circulated on their own wings and under their own steam, without any lending or borrowing involved, merely by virtue of the underlying merchandise moving sufficiently fast to the ultimate gold-paying consumer.

In addition, and most importantly, the Real Bills Doctrine explained how it was possible to pay all those eager to earn wages *before* the product could be sold, in some cases as many as three months earlier than the final consumer could purchase the finished good! It was not *credit*, it was *clearing* that made the realization of these desiderata possible. By abuse of language the bill of exchange is also called an instrument of credit. To guard ourselves against confusion we must carefully distinguish between the two types of credit in calling the latter *self-liquidating*. This will remind us that it is liquidated at maturity with the gold coin released by the final consumer of the merchandise underlying the bill. Credit of the first type is not self-liquidating. It may have to be prolonged, if the light at the end of the tunnel still cannot be seen at maturity. All credit of this type must originate in savings. For example, the credit financing fixed capital, or the credit financing circulating capital in case of slow-moving consumer goods or big-ticket items sold on an installment plan must not be financed through the monetization of the bill drawn on the retail merchant. They must be financed through the bond market as distinct from the bill market.

Self-liquidating credit exists quite independently of savings. Its existence is not explained by the propensity to save. It is explained by the propensity to consume. These propensities are not inversely related. They are not the two sides of the same coin. In fact, they are independent variables. A third type, the propensity to hoard, provides a cushion between the two. Thus it is possible for the propensity to save and the propensity to consume to fall together. It means that people are hoarding goods. Conversely, if they rise together, it means that people are dishoarding previously hoarded goods.

The discount rate is not set by the banks. It is governed directly by the consuming public and varies inversely with the propensity to consume. In more details, the discount rate is the inducement to move the retail merchant to prepay his bill before maturity. It should be clear that the lower is the propensity to consume, the greater the inducement must be: it takes longer for the merchandise to clear the shelves. The converse is also true: the higher the propensity to consume, the lower is the discount rate. The cash flow of the retail merchant is greater and he is anxious to put some of his spare cash to work. He does it by prepaying his bills, to earn extra income in the form of saved discount. This also shows that the discount rate has nothing whatever to do with the rate of interest, which varies inversely with the propensity to save. The economic forces governing these two rates are entirely different. It is a grave error to suggest that the discount rate is but a subset of the rate of interest, namely, interest on short-term loans. The two rates must be studied separately if we want to understand the circulation of gold coins and properly issued bank notes in the economy.

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When World War I broke out, international trade in consumer goods came to a virtual halt, and so did also trade in real bills. The garrison states that emerged after the war would not allow international bill trading to make a comeback. Their aims, to subordinate trade in consumer goods across boundaries to political rather than economic considerations, and to concentrate monetary gold in bank vaults, were not compatible with bill trading which assumed that the gold was outside of the banks in the hand of the wage earning and consuming public. In depriving them of their gold coin governments disenfranchised the wage earner and the consumer. Henceforth producers would not take orders from them. They would take orders only from the banks, the issuers of purchasing media, or from the government in which the new dispensation has vested the ownership of gold.

In vain did the governments try to keep the trappings of a gold standard after the war. It was only a matter of time before the gold standard, bereft of a clearing system, would break down under the strain of world trade, much reduced though it was as compared with its pre-war volume. Financing international trade with gold but without real bills put an enormous yet unnecessary burden on savings. In effect, the managers of this new "cash-and-carry-gold-standard" were attempting the impossible. They wanted to convert the head of a pin into a grand ballroom where all the angels of high heaven could dance together. They wanted to finance all circulating capital out of savings. They attempted to institute what Rothbard later called "100 percent gold standard". Their efforts were doomed to failure.

The international gold standard did not break down because of a shortage of gold, as alleged by government statisticians. It is true that as a result of the war prices and wages had moved to a higher level and they were too "sticky" to come down after war-time shortages were over and destruction healed. But there is no telling how much trade in consumer goods a given amount of gold can support at a given price level, provided that the clearing system of the gold standard is not being sabotaged.

Worst of all, under the regime of "cash-and-carry" wages could no longer be paid in advance of the sale of goods to the ultimate consumer. The wage fund of the sector providing goods and services to the consumer has been destroyed. Unemployment and bankruptcies followed. The world was plunged into the Great Depression. In throwing out the bath water of real bills governments have thrown out the baby of full employment.

We are not arguing here that the destruction of the clearing system of the international gold standard was the only cause of the worldwide unemployment in the 1930's. Obviously, other causes played a role as well, for example, the monopoly power granted to trade unions, which used it to extort uneconomic wage settlements from the employers. However, we shall argue that the expulsion of real bills from financing world trade in consumer goods was the major cause, one that has undeservedly been ignored by scholarship.