THE ROOT CAUSE OF UNEMPLOYMENT
Part 2

Real Bills and Employment

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In Part I we elaborated on the thesis of the German economist Heinrich Rittershausen that the appalling world-wide unemployment of the 1930's was caused by the coercive legal tender laws of 1909. The chain of causation is as follows: the French and German governments, in preparation for the coming war, wanted to concentrate gold in their own coffers. They stopped paying civil servants in gold coin. To make this practice legal they had to enact legislation that gave bank notes legal tender status.

Scarcely did these governments realize that in doing so they set a slow process into motion which, in the end, destroyed the wage fund out of which workers could be paid even before merchandise has been sold to the ultimate consumer. In this second part we examine in greater detail how the wage fund was financed before 1909. We shall see that the bill market is just the clearing system of the gold standard. If disabled, sooner or later the gold standard will collapse as a result.

We hope that detractors of the Real Bills Doctrine will read this analysis with an open mind, and give their best effort to find a weak point in the argument (if they can), to refute our conclusion, which is as follows. If the victorious powers had allowed the bill market to make a come-back, and they had rescinded legal tender laws at the end of hostilities in 1918, then the gold standard would not have collapsed in 1931, and there would have been no world-wide unemployment and no Great Depression.

Bank notes as self-liquidating credit

Previous to 1909 circulating capital for the production of consumer goods in urgent demand had been financed, not out of savings, but through discounting real bills at a commercial bank, which would then rediscount them at the bank of issue that supplied the country with bank notes. To be sure, these bank notes represented self-liquidating credit. They were merely a more convenient form of the bill of exchange from which they derived their potency. They came in standard denomination round figures. Unlike the bill of exchange they could without hassle and loss be broken up into smaller units. The great convenience they offered was valued by the public so much so that people were willing to pay for it in the form of forgone discount.

When the bill matured and was paid, the bank note was retired. For this very reason it was not inflationary. The bank of issue would under no circumstances prolong credit beyond the maturity date of the rediscounted bill. If the underlying merchandise could not be sold in 91 days, then it would not be sold in 365 days, certainly not before the same season of the year came around once more. But by that time the merchandise would be stale and could only be sold at a loss, if at all. Prolonging credit on a mature bill would violate the letter and spirit of the law governing central banking in Germany prior to 1909.

Could a commercial bank, nevertheless, roll over a real bill at maturity? On strictly economic grounds it wouldn't. First of all, it would forfeit its rediscounting privileges at the bank of issue if it did. Secondly, it would make its portfolio less liquid and so it could no longer compete successfully with more liquid banks. Having said this, we must admit that in practice some banks may have been guilty of rolling over mature real bills for various reasons. At the benign end of the spectrum the reason could be a false sense of loyalty to clients; at the malignant, conspiracy with them in speculative ventures. It was this latter practice that Ludwig von Mises could have properly condemned as ‘credit expansion’. Be that as it may, unethical behavior on the part of some banks should be no grounds for issuing a blanket condemnation of all banks and calling the legitimate practice of discounting real bills ‘credit expansion’ with a disapproving connotation.

The lesson from negative past experience must be learned and, in the future, full disclosure ought to be mandatory for commercial banks discounting bills. They should be obliged by law to publish their portfolio of real bills quarterly. Clients would thus be enabled to identify delinquent banks which habitually make their portfolio illiquid by sheltering dubious assets such as bills doing overtime after maturity, as well as finance or treasury bills. Thereupon discriminating clients could take their business elsewhere, to more liquid banks.

The retired bank note could not be re-issued until and unless a fresh bill representing new merchandise in urgent demand was offered for rediscount, or gold was offered for sale to the bank of issue. Re-issuing it under any other circumstances, say, lending it out at interest, or extending commercial credit to cover the unsold merchandise after maturity, would violate its charter. It would be tantamount to extending commercial credit under false pretenses.

Real bills *versus* financial bills

The changeover from bank notes backed by real bills to bank notes backed by financial bills was the last nail in the coffin of the clearing system of the international gold standard. Monetary scientists and others with intellectual power to grasp the intricacies of bank note circulation raised their voice condemning the new paradigm. They objected to making financial or treasury bills eligible for rediscount, a practice that had previously been prohibited by law with stiff penalties for non-compliance. Most people could not understand what the fuss was about. But there was a world of a difference between rediscounting real bills and rediscounting financial bills. It was the difference between self-liquidating credit and non-self-liquidating credit. Real bills could rely on a huge international bill market with its practically inexhaustible demand for liquid earning assets. Not so financial bills which were backed by the odds that speculative inventory of goods and equities or investment in brick and mortar may be unwound without a loss by the date of maturity. Treasury bills were backed by future tax receipts. If anticipation attached to financial and treasury bills did not materialize in time, then at maturity they would have to be rolled over. This was borrowing short and lending long through the back door, carrier of the seeds of self-destruction.

The chimera of ‘fractional reserve banking’

Financial bills have made the asset portfolio of the bank of issue illiquid. The bank could no longer satisfy potential demand for gold coins, should holders of bank notes decide to exercise their legal right to redeem them. To take away this right was the reason for making bank notes legal tender in the first place in 1909. We must remember that redemption wouldn’t be a problem so long as the portfolio consisted of real bills exclusively. Every single day one-ninetieth of the outstanding bank notes matured into gold coins which were available for redemption. This would normally satisfy daily demand. But what about abnormal demand for gold coins?

A real bill is the most liquid earning asset in existence. At any time somewhere in the world there is demand for it. In particular, banks that have a temporary overflow of gold would be more than anxious to exchange it for real bills. The bank of issue would not have the slightest difficulty to get gold in exchange for real bills in the international bill market. Once upon a time the Bank of England boasted that “it could draw gold from the moon by raising the rediscount rate to 5%.” The assumption that there will always be takers for real bills offered for sale is just as safe as the assumption that people will want to eat, get clad, keep themselves warm and sheltered tomorrow and every day thereafter.

This explodes the blanket condemnation of ‘fractional reserve banking’. Detractors are barking up the wrong tree. They should condemn the practice of rediscounting financial or treasury bills. Real bills were self-liquidating, while financial and treasury bills had impaired liquidity. Under certain circumstances the latter might become unsaleable. They are simply unsuitable to serve as bank reserves.

By contrast, real bills are the most liquid earning asset a bank can have, as already pointed out. There is always a ready market for them as other banks with excess gold scramble to get liquid earning assets. It is a grave error to equate fractional reserve banking with liquid reserves (real bills) to that with illiquid reserves (financial bills and treasury bills). We may remark here that the term ‘fractional reserve banking’ is a misnomer when applied to a bank utilizing real bills. The note issue is *fully backed* partly by gold and partly by short-term gold instruments so that the sight liabilities of the bank are at all times are payable in gold.

This problem has been thoroughly researched by a host of competent experts in the 19th century. There is a voluminous literature on this subject. It was not produced by “monetary cranks” or by “inflationists”. It was produced by the best minds dedicated to sound monetary and fiscal policy. Their unanimous judgment still stands: real bills, to the exclusion of financial and treasury bills, are by far the safest earning asset that a bank of issue can have. Prior to 1909 charters of the banks of issue explicitly made financial and treasury bills ineligible for rediscounting. Moreover, the laws governing central banking prohibited the use of government paper for the purposes of backing the note circulation, and prescribed heavy penalties for non-compliance. This was the corner-stone of central banking of the liberal era which kept the lessons of the French revolution with its paper-money inflation in evidence. This was not a controversial issue. Informed people could distinguish between safe banking that utilized real bills, and unsafe banking that utilized financial and treasury bills to back the note issue. Their judgment is epitomized by the old saying that “the easiest profession in the world is the banker’s, provided that he can tell a mortgage and a real bill apart”.

It is regrettable that latter-day critics are not sufficiently familiar with this particular body of knowledge and confuse fractional reserve banking based on *sound assets*, with fractional reserve banking based on *unsound assets*. It is ironic that they do exactly the same, ostensibly in the name of sound money, what enemies of freedom have done and are doing in the name or irredeemable currency, namely, wipe out the important distinction between liquid and illiquid bank reserves.

Deus ex machina

The process of retiring the bank note after the merchandise serving as the basis for its issue has been removed from the market by the ultimate gold-paying consumer is called “reflux”. Several authors, including Ludwig von Mises, ridiculed the concept calling reflux *deus ex machina*. They argued that the banks were only interested in credit expansion, not in reflux. Banks would not for one moment think of withdrawing a corresponding amount of bank notes from circulation when the real bill matured. Instead, they would lend them out at interest in order to enrich themselves at the expense of the public. This is not a valid argument. For the stronger reason, you could also ridicule the entire legal system asking the rhetorical question: “what is the point in making laws when they will be broken anyhow?” You can’t judge the merit of an institution by the behavior of those who are set upon destroying it.

Let us follow the trail of gold coins through the path of reflux. Our description that follows is necessarily schematic. For the sake of simplicity we assume that only wholesaler-on-retailer bills are discounted. This is reasonable as these bills are more liquid than producer-on-wholesaler bills, or higher-on-lower-order-producer bills. We also assume that the retailer is expected to pay his bill with gold coins flowing to him from the consumers. Gold serves as proof that the merchandise underlying the bill has been sold to the ultimate consumer and is not held, contrary to purpose, in speculative stores in anticipation of a price rise. Finally, our description follows the practice of the German banking system as it was before 1909. The practice elsewhere may have been different, but the essential idea would be the same: with the sale of merchandise the gold coin was recycled from the consumer through the retail merchant to the commercial bank, from where it would be withdrawn by producers in order to pay wages, thus putting the gold coin back into the hand of the consumers. Then the cycle of supplying the consumer with urgently demanded merchandise could start all over again.

In more details, as the gold coins flowed from the consumer to the retail merchant, the latter deposited them at the commercial bank. When he was ready to replenish his depleted inventory the retailer would order a fresh supply from the wholesaler and, after endorsing he would return the bill to the latter who would discount it at a commercial bank. The wholesaler would take the proceeds in the form of bank notes which the commercial bank obtained from the bank of issue through rediscounting.

The wholesaler would use the bank notes to pay the producer of first order goods. The latter would use them to pay the producer of second order goods, and so on. But when it came to paying wages, all these producers had to draw out gold coins from the commercial bank against bank notes. They could do no worse than the government that paid civil servants in gold before 1909.

Upon maturity the commercial bank used the bank notes to pay the rediscounted bill at the bank of issue. The latter was under obligation by law to retire these bank notes. It could not lend them out at interest. If it did, it would violate the law, and would have to pay heavy penalties. Retired bank notes could be used for only two legitimate purposes: either to buy gold, or to rediscount fresh bills drawn on new consumer goods moving to the ultimate gold-paying consumer. Since lending and discounting were two entirely different banking functions, this was *not* the same as lending the notes out at interest.

Now the gold coin was in the hands of the wage-earner. As he spent it on consumer goods, he enabled the retail merchant to make payments on his discounted bill at the commercial bank with gold. When paid in full, the bill was returned to the retail merchant. The bill's ephemeral life as a means of payment has come to an end. But the march of gold coins would continue. They would be withdrawn by the producers to pay wages, and the cycle of supplying wage-earners with consumer goods against payment in gold coin could start all over again. Gold coin circulation in the production cycle is akin to water circulation through evaporation and precipitation in the atmospheric cycle. This cycle was short-circuited by the 1909 decision of France and Germany to make the note issue legal tender while paying civil servants in notes rather than gold coin.

A stone mason called Michelangelo

The havoc that the monetary *coup d'état* of 1909 would wreak upon society had not been foreseen. Nor was the causal relation between the expulsion of real bills from the portfolio of the bank of issue and massive unemployment two decades later. Almost one-half of trade union members, or 8 million people, lost their jobs in Germany alone.

Real bills finance the movement of consumer goods, including wages paid to people handling the maturing merchandise through the various stages of production and distribution. The size of circulating capital needed to move the mass of consumer goods through these stages, if financed out of savings, would be staggering. Quite simply, it could not be done. No conceivable economy would produce savings so generously as to be able to finance circulating capital for the production of all the consumer goods that society needed in order to flourish at present levels of comfort and security.

Fortunately there is no need to employ savings in such a wasteful manner. It is true that fixed capital must be financed out of savings. As a result, creation of fixed capital depends on the propensity to save. Not so circulating capital, provided that the merchandise moves fast enough to the ultimate gold-paying consumer. It can be financed through self-liquidating credit which depends on the propensity to consume, and is independent from the propensity to save.

The discovery of this fact is one of the great achievements of the human spirit and intellect.

It was made by the giants of the Renaissance who believed that "man is the measure of all things". Theirs was a feat on a par with the discovery of indirect exchange. The impact upon human life of the invention of the circulating bill of exchange is fully commensurate with that of the invention of the wheel. By the same token, banning of real bills is akin to outlawing the wheel. What would have happened to the quality of human life if the use of the wheel had been banned by the governments in the middle ages?

Detractors have missed one of the most exciting developments in the history of our civilization, namely, the discovery of self-liquidating credit in the wake of the disappearance of risks in the production process as the maturing good gets within earshot of the final gold-paying consumer. Their failure is not unlike dismissing Michelangelo as 'just another stone mason'.

Mistaking the back-seat driver for the boss in the driver seat

Pari passu with the emergence of the need for consumer goods the means to finance their production and distribution emerges as well. It is in the form of the bill of exchange. Retailers, wholesalers, and producers of first-order goods hardly ever pay their suppliers cash. "91 days net" is invariably part of the deal, to give ample time for the merchandise to reach the ultimate gold-paying consumer. Producers of higher-order goods could fold tent and go out of business if they insisted on cash payment for the supplies they were providing. It was the producers of lower-order goods who were the boss and called the shots, by virtue of being that much closer to the ultimate consumer and his gold coin. They would laugh you out of court if you told them that they have just been granted a loan by the producer of higher-order goods, and the discount is just interest taken out of the proceeds in advance. They know better. They know that self-liquidating credit is theirs for the taking. They know that the discount rate has nothing to do with the rate of interest. For a consideration they may be willing to prepay their bill before maturity. The privilege is theirs, and theirs alone. Discount is just the consideration offered to tempt them. Those who insist that the producer of higher-order goods is the lender and the producer of lower-order goods is the borrower or, alternatively, the wholesaler is the lender and the retailer is the borrower, do not know what they are talking about. They are mistaking the back-seat driver for the boss in the driver seat.

Quantity Theory of Money

If the victorious powers had realized that the wage fund was destroyed, then they would have tied the emergence of bank notes to the emergence of real bills once again after World War I. They would have also repealed the legal tender laws. This remark puts the Quantity Theory of Money in a rather dim light. This theory holds that "money is money"; it has one dimension only: *quantity*. To talk about the *quality* of money is hallucinatory. Money can be produced in any quantity synthetically. If employment falls or prices decline, they can be compensated for by an increase of the quantity of bank notes outstanding.

The fact that this view reflects a grave error is proved by the bitter experience of the twentieth century. While it is true that the quantity of bank notes outstanding can be increased *ad libitum*, the bank of issue is absolutely helpless if it wants to prescribe how the public should use its freshly printed notes. They may flow to the bond market, but they could just as well flow to the stock market. Accordingly, they may bid up bond prices (drive down interest rates), but they could just as well drive up equity prices. The quantity theory blithely assumes that newly printed bank notes are duty bound to flow to the labor market to put people to work. However, it is always the quality of money, never its quantity, that will decide where new money will flow. Furthermore, the quality of bank notes cannot be examined without scrutinizing the assets which the bank of issue holds against them. Second only to gold, the best assets the bank of issue can have are the self-liquidating real bills.

If we want the newly printed bank notes to increase employment and production, rather than merely stoke the fires of speculation, then we have to restore the nexus between their printing and the emergence of new goods in the production process. We must rescind coercive legal tender laws. We must rehabilitate the spontaneous international bill market.

We must have a gold standard cum *real bills.*

References

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