

# THE WISDOM OF ADAM SMITH FOR OUR OWN TIMES

— *A Rejoinder* —

Let us celebrate the 291st birthday of the great Scottish economist together  
and let us rehabilitate his Real Bills Doctrine!

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Richard Ebeling in the June 3rd issue of the Daily Bell under the same title contributed a much needed reminder of the relevance of Adam Smith's wisdom to our contemporary world. I am not going to speculate whether the omission of not mentioning Adam Smith's Real Bills Doctrine was accidental or deliberate. However, it is well known that post-Mises Austrian economists have taken a disdainful view of the Real Bills Doctrine and it would have been nice to have Ebeling's coherent articulation of their position. I can do no better than revisiting Adam Smith's great contribution to the theory of money and credit (which, significantly, received the *nihil obstat* of Carl Menger a hundred years later) for the benefit of the Daily Bell's readership.

## **Consumption as a source of credit**

Adam Smith's insight that consumption, next to savings, is another fundamental source of credit was one of the great discoveries of economics, comparable in importance to Carl Menger's subsequent discovery of marginal utility as the source of value. We owe the concept of *social circulating capital* (SCC) to Adam Smith. By this he meant that part of the flow of consumer goods in most urgent demand that is moving sufficiently fast to the ultimate consumer so that it will be removed from the market in 91 days (the length of the seasons of the year in our temperate zone). For example, items like bread, seasonal garments and firewood in winter will

unquestionably be consumed in definite quantities and do thus belong to SCC; items like grain held for speculative gains, unsold garments left over from the previous season and firewood in summer do not. Producers and distributors handling goods that form part of the SCC enjoy special privileges and have special responsibilities due to the special place their product occupies in the constellation of economic goods. They don't have to face uncertainties and don't have to carry risks all other producers and distributors have to face and carry. They do not finance their production under the relatively harsh terms of the interest-rate regime. They can finance it under the relatively more lenient terms of the discount-rate regime.

SCC has been compared to a great river that empties into the infinite ocean of consumption. The salinity of water undergoes important changes downstream as the river gets within earshot of the ocean. Fish habitat prospering in these waters changes. Similarly, important changes occur in the type of credit financing production and distribution of goods downstream as the ultimate consumer is getting ready to remove them from the market in less than 91 days. In particular, the gold coin need not be saved in advance of production. Financing is done retroactively with the gold coin released by the ultimate consumer.

### **Drawing a bill**

The wholesale merchant delivers the finished good to the retail merchant (or the higher-order producer delivers the semi-finished good to the lower-order producer). Adam Smith observed that hardly ever does the latter pay with gold coins, and *never* does the former demand payment in gold coin. Invariably the former, called the *drawer*, bills the latter, called the *acceptor* or the *drawee* of the bill. The face value of the bill is payable in gold coin upon maturity, not more than 91 days later. The signature of the acceptor acknowledges receipt of goods listed on the face of the bill. It also acknowledges his responsibility for payment. The bill so accepted is returned to the drawer. Only in the rarest of instances would the drawer keep the bill and present it for final payment upon maturity — as observed by Adam Smith. More commonly, he would offer it to his own suppliers in payment when replenishing his inventory. They would be glad to take it because they know that they themselves could likewise use it when it is their turn to replenish their depleted inventory. In other words, the bill goes into spontaneous monetary circulation. Paying the supplier with a maturing bill drawn on a third party is called *discounting* it since the face value is subject to discount by the number of days remaining to maturity. Discounting is accompanied by the endorsement of the bill on the back, signifying the last endorser's transferring the title to bearer. When the bill matures, face value is typically paid by the drawer's bank, often the first endorser of the bill.

To suggest that the drawer extends a loan to the drawee, and that the discount represents interest taken out of the loan up front, is a travesty □ as Adam Smith and Carl Menger would readily confirm. If anything it is the drawee who is in the stronger position, by virtue of being closer to the ultimate consumer on whose gold coin the whole transaction turns. After all, it is this gold coin that will liquidate a whole string of claims upon maturity. As the bill is passed along from one endorser to the next, the underlying semi-finished good assumes ever greater marketability. The drawee is handling goods more marketable than that handled by the drawer. Put in this light, it is preposterous to suggest that the drawee is a debtor and the drawer is a creditor. The transaction under consideration is definitely not one of *borrowing*. It is one of *clearing*: the process of canceling claims and counter-claims at maturity among various parties to the same deal. Their relationship is one of cooperation between collaborators; not one of confrontation between creditors and debtors.

Nor is *savings* the source of commercial credit. The true source is *consumption*. The intensity of the demand for consumer goods is the driving force, fully capable of creating its own source of credit quite independently of savings. It is conceivable for commercial credit to exist even in the hypothetical absence of savings. The error in confusing interest and discount, although quite common, could be fatal as I shall show below. The rate of interest is a measure of the *propensity to save* while the rate of discount is a measure of the *propensity to consume*. Although in either case the rate varies inversely with the propensity, yet the two rates spring from entirely different sources, and are shaped by entirely different forces.

### **How does discount arise?**

*Discount arises in the first place as an option of the retail merchant to prepay his bills.* When due to overwhelming consumer demand he finds himself in the position that his till spills over with gold coins, he will offer to *discount* his bills, that is, to prepay face value discounted by the number of days left to maturity. Implicit in discounting is the *discount rate* at which the discount is calculated. The fact that the retail merchant insists on a concession in the form of a discount is *not* due to time preference. Rather, it exclusively is due to the fact that the alternative of buying a bill with the same maturity drawn on a fellow retail merchant at a *lower* price is available to him.

Adam Smith's theory of commercial credit independent of savings was pejoratively named the Real Bills Doctrine by its detractors. They flatly denied the spontaneity of bill circulation. They vehemently insisted that the discount was due to time preference and nothing else. They condemned the whole scheme as a conspiracy, a

backhanded way to inflate the money supply. This criticism is plainly wrong: a real bill arises simultaneously with the emergence of new merchandise and it expires together with the removal of that merchandise from the market by the ultimate gold-paying consumer. Inflation of the money supply does not enter into it. This fact makes the real bill the next best thing to the gold coin itself. In one sense it is even better: it earns a return in gold.

Existence of commercial banks is *not* a prerequisite to bill circulation. But if banks are given, then they cannot have better earning assets than real bills to cover sight liabilities. The demand for real bills is virtually unlimited, so that the banks can get ready cash by selling bills from portfolio if they run into unusual drain of gold. Indeed, demand for real bills comes not only from other commercial banks experiencing unusual increase in their gold reserves. Demand also comes from anyone with gold obligations to be met at a future date. For example, issuers of bonds to mature during the next quarter do not accumulate gold itself in anticipation of their obligation. Rather, they accumulate real bills with the same maturity.

SCC is not a fixed quantity. It waxes and wanes together with changes in the propensity to consume. The appearance of marginalism a hundred years after the *Wealth of Nations* was published presented an opportunity to refine Adam Smith's theory of commercial credit by introducing concepts such as the marginal item in SCC, the marginal retail merchant, the marginal productivity of SCC. In particular, the marginal retail merchant is seen as doing arbitrage between SCC and the bill market. At the first sign of falling consumer demand he withdraws his standing order for marginal goods on his shelf and redeploys his capital in the bill market instead. Conversely, when consumer demand picks up again, he will liquidate part of his bill portfolio and orders new marginal merchandise displaying it on the shelves. Clearly, this arbitrage is the engine behind the variation of the discount rate. Note that the discount rate is much more nimble than the sluggish rate of interest. It depends directly on the caprice of the consumer. This observation challenges the traditional supply/demand equilibrium theory of price: *changes in demand act not on the price but on the discount rate*. The extension of Adam Smith's thought to incorporate marginalism culminates in the theorem stating that *the discount rate is equal to the marginal productivity of SCC*. An increase in marginal productivity means that the marginal item drops out from SCC so that the productivity of the new marginal item is relatively higher than that of the old was. Conversely, a falling discount rate sends a telegraphic message to all producers and distributors to increase their offering: 'consumer confidence' is on the rise once again. Incidentally, this is the reason why the price of fuel is normally not higher in winter than it is in summer — predictions of the supply/demand equilibrium theory of price notwithstanding.

## Relevance of Adam Smith's Real Bills Doctrine in our own times

The first casualties of the Guns of August one hundred years ago, in 1914, were the real bills financing, as they did, world trade in consumer goods. This was not in itself surprising. What was surprising, however, was the failure of real bills to reclaim their former paramount place in financing world trade after the cessation of hostilities in 1918. In retrospect it is abundantly clear that there was an unannounced political decision made behind closed doors to block the international trade in real bills. Without such a decision real bills would have started circulating spontaneously. Real bill financing of trade is synonymous with *multilateral* trade. The victorious Entente powers wanted none of that. They wanted *bilateral* trade instead. They were scared stiff of German competition. They thought they could control German exports and imports that way. According to the terms of the peace treaty they had to lift their *blockade* on Germany but, at the same time, they could *block* the international bill market to the same effect — and they did. Real bills were not allowed to make a comeback during the intervening one hundred years. Scarcely did the victorious Entente powers realize that in blocking the bill market they were shooting themselves in the foot. Their action destroyed the Wage Fund, thereby causing horrendous unemployment and the Great Depression of the 1930's. In the meantime a formidable official propaganda machinery was launched to discredit Adam Smith's Real Bills Doctrine. Economists of the Age of Keynes, Austrians included, failed miserably to discharge their duty to search for and disseminate truth. It never occurred to them that there was a reason why '*structural unemployment*' prior to *World War I* was *unknown and non-existent*. Real bill trading effectively eliminated that threat.

Economists should have made the fact clear that the Great Depression was in effect caused by the destruction of the Wage Fund — a direct consequence of the unannounced decision to block international trade in real bills. Workers producing the great mass of consumer goods cannot wait three months for their wages to be paid, until after their product is sold for cash. The fact that they could be paid weekly (and the fact that there was no structural unemployment before World War I) was entirely due to the existence of the Wage Fund consisting of real bills in circulation. The unannounced decision to block the bill market sealed the fate of the workers. The Wage Fund having thus been destroyed left no one around to advance the wages of the workers. Unprecedented unemployment ensued — following the unprecedented blocking of the bill market. Structural unemployment has been artificially created that was to plague the world for the next one hundred years. A very high price was exacted for ignoring the wisdom of Adam Smith. The great damage caused by the

forcible elimination of the bill market has gone unrecognized for a century. It all boils down to the fatal confusion between interest and discount, between bilateral and multilateral trade.

The way towards building a better world in the twenty-first century leads through the unconditional and full rehabilitation of Adam Smith's Real Bills Doctrine. Starting with the most marketable staple goods: food, fuel and fodder, real bill financing of world trade must be reintroduced. Since real bills must mature in gold coins (it would be preposterous if they were made to mature in an instrument of *lesser* marketability – and irredeemable currency notoriously has badly impaired marketability), gold coin circulation must also be restored.

Only then will future generations be able to look back on our insane experiment with global irredeemable currency in the twentieth century as a brief reactionary episode, trying to expunge the wisdom of Adam Smith from the consciousness of mankind.

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