MONETARY REFORM: GOLD AND BILLS OF EXCHANGE

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Introduction

The Great Depression of the 1930's was not due to the 'contractionist propensities' 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 government's sabotaging the clearing system of the international gold standard, 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, and to lengthen production processes in making them 'more roundabout' in order to improve the efficiency of labor and capital — without causing monetary contraction through unnecessarily invading the pool of circulating gold coins, and without tying up savings in order to finance circulating capital. Clearly, additional fixed capital can only be financed through increased savings. Additional circulating capital, however, need not involve savings: it can be financed through improvements in clearing. Circulating capital can be self-financing, provided that the goods involved are demanded urgently enough by the consumers.

In this address I look forward to the release of the gold standard from a forty-year quarantine, to become one of the pillars of the reconstruction after the present credit collapse has run its course. In order to be viable, the new gold standard has to have a valid clearing system. Bill circulation would spring up spontaneously. In other words, we have to have a gold standard of the type that prevailed in the world prior to 1914, when international trade was financed not through gold flows across national boundaries, but through trading bills of exchange drawn on London. It would not be a gold exchange standard as that of the years 1920-1971, with government promises to pay replacing real bills. But it would not be Murray Rothbard's so-called 100 percent gold standard either, which is phantasmagoria.

Self-liquidating credit

In spite of obvious differences between the two, it is customary to extend the concept of credit to include clearing. In more details, in addition to credit arising out of the *propensity to save* that finances fixed capital, we also consider self-liquidating credit arising out of the *propensity to consume* that finances circulating capital. The latter does not involve lending; it involves clearing.

Goods making up circulating capital must be in the final phases of production and distribution, and they must move sufficiently fast to the ultimate, gold-paying consumer. Thus, then, the bill of exchange is the embodiment of self-liquidating credit — so called as the credit is liquidated directly with the gold coin surrendered by the consumer in 91 days or less (91 days being the length of the seasons of the year in the temperate zones, forcing a change of the types of merchandise in greatest demand).

Detractors of the Real Bills Doctrine studiously avoid reference to its prestigious pedigree and its author, Adam Smith. They also ignore the fact that, as a matter of merchant custom, producers and distributors hardly ever pay cash for the maturing merchandise as it is passed on from one hand to the next. Instead, they endorse the bill of exchange and, in doing so, assume liability to pay it at maturity. This transaction is called 'discounting' as the payee applies an appropriate discount, calculated at the current discount rate, to the face value of the bill, proportional to the number of days remaining till maturity. Banks need not be involved.

Chicken or egg?

Such a bill circulation was universal in the city-states of Italy during the Quattrocento and, more recently, in 18th century in Lancashire before the Bank of England opened its branch in Manchester. This was duly observed by Ludwig von Mises in his 1912 treatise *The Theory of Money and Credit*, although he stopped short of investigating the economic forces animating spontaneous bill circulation.

Unlike the question whether chicken was first or the egg, the question whether bills or banks came into existence first has a definite answer. Logically and historically, bills predated banks. What is more, it is perfectly feasible to have an economy without banks, where circulating bills emerge as suppliers deliver semi-finished consumer goods to the producers. Instead of recognizing this fact, detractors link bills and banks as if they were Siamese twins. They are not.

A 'fairy' tale

Let us look at another historical instance of clearing that was vitally important in the Middle Ages: the institution of city fairs. The most notable ones were the annual fairs of Lyon in France, and Seville in Spain. They lasted up to a month and attracted fair-goers from places as far as 500 miles away. People brought their merchandise to sell, and a shopping list of merchandise to buy. One thing they did not bring was gold coins. They hoped to pay for their purchases with the proceeds of their sales. This presented the problem that one had to sell before one could buy, but the amount of gold coins available at the fair was far smaller than the amount of merchandise to sell. Fairs would have been a total failure but for the institution of clearing. Buying one merchandise while, or even before, selling another could be consummated perfectly well without the physical mediation of the gold coin. Naturally, gold was needed to finalize the deals at the end of the fair, but only to the extent of the difference between the amount of purchases and sales. In the meantime, purchases and sales were made through the use of scrip money issued by the clearing house to fair-goers when they registered their merchandise upon arrival.

Those who would call scrip money "credit created out of nothing" were utterly blind to the true nature of the transaction. Fair-goers did not need a loan. What they needed, and got, was an instrument of clearing: the scrip, representing self-liquidating credit.

Goods in bottoms

Another example of clearing in action is world trade prior to 1914. Suppose a cargo ship is ready to sail from Tokyo to Hamburg carrying in its bottom consumer goods in urgent demand. The sea-voyage takes up to 30 days with several stops *en route*. Does the importer need to raise a loan to pay the supplier for the goods in the bottom prior to sailing? Hardly. The merchandise has a ready market upon arrival. The cargo is insured against losses at sea. Accordingly, the supplier bills the importer for value received f.o.b. Tokyo, payable in 30 days in London. The importer endorses the bill, attaches the insurance documents, and sends it back to the supplier. The boat is now ready to sail. The supplier has an instrument he could use as ready cash to pay his own suppliers, or he can keep the bill to maturity as an earning asset. When the boat docks in Hamburg, the local wholesale merchant pays for the cargo with a sight bill on London with which the importer can meet his maturing obligation. No loan or lending is involved in all this, only clearing. The pool of circulating gold coins has not been invaded, nor are savings tied up for 30 days while the goods in urgent demand move from the Far East to Western Europe.

The tale of the cuckoo's egg

1909 was a milestone in the history of money. That year, in preparation for the coming war, the note issue of the Bank of France and of the Reichsbank of Germany were made legal tender. Most people did not even notice the subtle change. Gold coins and bank notes kept circulating as before. It was not the disappearance of gold coins from circulation that heralded the coming destruction of the world's monetary and payments system. It was the advent of legal tender. It was the French and German government's decision to stop paying civil servants in gold coin who were now forced to accept paper money. Private firms immediately followed suit: they also started paying their employees with bank notes. Never mind that the bank notes were redeemable in gold coin; this change effectively meant sabotaging the clearing system of the international gold standard. It short-circuited bill circulation. Bills were supposed to be paid at maturity in the form of a *present* good, the gold coin, obtained from the consumer who, in turn, was supposed to get paid in gold coin by his employer on every payday. Now they were paid in the form of a *future* good, the bank note. Legal-tender coercion created a leakage in the gold circulation process.

The banks continued using real bills as an earning asset to back the note issue. But other subtle changes were to alter the character of the world's monetary system beyond recognition. The cuckoo has invaded the neighboring nest to lay her egg surreptitiously. In addition to bank notes originating in bills of exchange, bank notes originating in finance bills (including treasury bills) have made their appearance for the first time. In due course the cuckoo chick would hatch and push the native chick out of the nest. In five years, by 1914, the lion's share of bank portfolios would be replaced by finance bills. The real bill has become an endangered species. In another few years it became extinct. Note that, unlike real bills, finance and treasury bills *are not* self-liquidating. The change-over from bank notes backed by real bills to bank notes backed by finance bills was the last nail in the coffin of the clearing system of the international gold standard.

Borrowing short and lending long

Finance bills are backed by the odds, never the certainty, that a speculative inventory of goods, or equities, or investments in brick and mortar, may be unwound without a loss. If the odds do not play out in time, the finance bill will be 'rolled over'. This is tantamount to borrowing short and lending long — invitation to disaster. By contrast, a real bill are never ever rolled over. If not paid in gold upon maturity, the drawer of the bill will go bankrupt and his name will be blacklisted at the clearing house for good.

Finance bills made the portfolio of banks illiquid. Potential demand for gold coins, should holders of bank notes want to exercise their legal right to redeem them, could no longer be satisfied. To take away this right was the reason for making bank notes legal tender in the first place. Redemption would never be a problem as long as the banks' assets consisted of real bills exclusively. Every single day one-ninetieth of the outstanding bank notes would mature into gold coins, which were available for redemption. Normally this would suffice to satisfy daily demand.

But what about abnormal demand? Well, a real bill is the most liquid earning asset that a bank can have. 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. Thus banks would not have the slightest difficulty to get gold in exchange for real bills in the international bill market. The assumption that there will always be takers for real bills offered is just as safe as the assumption that people will want to eat, get clad, keep themselves sheltered and warm tomorrow and every day thereafter.

The chimera of fractional reserve banking

This explodes the blanket condemnation of fractional reserve banking. Detractors are barking up the wrong tree. They should condemn the practice of discounting finance bills. Actually, 'fractional reserve' as applied to banks with nothing but real bills in their portfolio is a misnomer. The reserves are gold plus bills *maturing into gold*. The reserves are not fractional, as they fully back the note and deposit liability of the bank. By contrast, if the bank portfolio has a component of finance bills, the designation 'fractional reserve' is appropriate. It may not be possible to get gold in exchange for finance bills when the crunch comes.

Reflux

The process of retiring bank notes, after the merchandise serving as the basis for their issue has been removed from the market by the ultimate gold-paying consumer, is called 'reflux'. Some authors, including Ludwig von Mises, have ridiculed the concept of reflux calling it *deus ex machina*. They argued that banks were only interested in credit expansion, not in reflux. Not for one moment would they entertain the idea of voluntarily withdrawing bank notes from circulation when the underlying real bill matured. Instead, they would lend them out at interest again and again, 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 in asking the rhetorical question: "what is the point of making laws when they will be broken anyhow?" You cannot judge the merit of an institution by the behavior of those who are set upon destroying it.

The highest achievement of the human spirit and intellect

The havoc that the silent monetary revolution of 1909 ushering in legal tender bank notes would wreak upon society had not been foreseen. Nor was the causal relation recognized between the expulsion of real bills from bank portfolios and the massive unemployment that followed it. In Germany alone, 8 million people, or nearly 50 percent of the trade union membership lost their jobs after 1929. Economists have failed to point out the causal nexus between the two events 20 years apart. Here is the explanation of what happened.

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. That part of the circulating capital paid out in wages is called the *wage fund*. The size of the wage fund 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 prodigiously as to be able to finance it as part of the circulating capital that society needed in order to flourish at present levels of security and comfort.

Fortunately, there is no need to employ savings in such a wasteful manner. Circulating capital can be financed through self-liquidating credit. *The discovery of this fact is one of the great achievements of the human spirit and intellect. The impact on human life of the invention of the circulating bill of exchange is fully* *commensurate with that of the invention of the wheel.* Detractors of the Real Bills Doctrine have missed one of the most exciting developments of our civilization: the discovery of self-liquidating credit as it emerges in the wake of the disappearance of risks at the end of the production process, when maturing goods get within earshot of the final gold-paying consumer.

Destruction of the wage fund

This near-perfect system was allowed to disintegrate in the wake of the 1909 legal tender legislation. *By 'crowding out' real bills from the monetary system, governments have inadvertently destroyed society's wage fund*. It was there to allow wages to be paid as much as 91 days in advance of merchandise being sold to the ultimate consumer. When real bills were replaced by non-self-liquidating finance bills, payment of wages has become haphazard. Employment was made touch-and-go, hiring, 'hand-to-mouth'. This threatened with unemployment on a massive scale, unless governments were willing to assume responsibility for paying wages. Eventually, to avoid undermining social peace, they had to do just that. Governments invented the so-called 'welfare state' paying out so-called 'unemployment insurance' to people who could have easily have found employment had the wage fund been preserved through ensuring the proper functioning of the bill market, the clearing system of the gold standard.

What has been hailed as a heroic job-creation program appears, in the present light, a miserable effort at damage control by the same government that has destroyed the wage fund in the first place. Economists share responsibility for the disaster. They have never examined the 1909 decision to make bank notes legal tender from the point of view of its effect on employment. They should have demanded that, instead of treating the symptom: unemployment, governments remove the cause of the disease: the destruction of the clearing system of the gold standard, the bill market. Had the governments allowed bill circulation to return at the end of the hostilities in 1918, the wage fund would have been replenished at once. Unemployment would not have arisen. Recall that it was not a problem before 1909.

The greatest fiasco of all times

The problem of destroying the clearing system of the gold standard by expelling self-liquidating credit from the system in 1909 was further aggravated in 1971 when the gold standard itself was destroyed. By 2008 the festering crisis has become a fully blown credit collapse, encompassing the entire globe.

We must have the humility to admit that it was our reckless experimentation with irredeemable currency and synthetic credit that resulted in this fiasco greater than any other man-made disaster in history. The runaway Debt Tower of Babel is toppling, and the quadrillion-dollar-strong global derivatives monster is vaporizing. There is no bottom to this collapse. The financial system is self-destructing. It is in a death-spiral. Every wave of losses in the mortgage market, in the stock market, in hedge funds, or in derivatives triggers a new wave of losses. This will continue until total exhaustion is reached.

It is futile to expect the Fed and the Treasury to regain control of the careening financial system, even if all the central banks of the world pooled resources. There are not nearly enough dollars in existence to cover the derivatives losses, despite the Fed's endless stream of bailout money, and despite the Treasury's endless stream of bailout bonds donated to the Fed for collateral, which the latter needs but hasn't got, to create more bailout money. Halving interest rates again and again is oil on the fire. It has been the main cause for capital destruction, and contributes directly to unemployment.

The way out

In discussing the necessary monetary reform to be introduced after the dust settled, the rehabilitation of the gold standard and its clearing system, the bill market, must be a matter of first priority. The main cause of the disaster was the elimination of self-liquidating credit from the international monetary system, a process that started in 1909 with the introduction of legal tender bank notes. It took almost a full century to run its devastating course before the financial system started unraveling in February, 2007. That is the date, it will be recalled, when the cost of credit-default swaps shot up first, the salvo marking the beginning of the end.

During that unfortunate century, the 20th, self-liquidating credit based on *positive* value, gold, was forcibly replaced with 'synthetic credit' based on *negative* value, debt. Once the regime of irredeemable currency was in place there was no way to rein in the fast-breeder of debt in the system. We are forced to draw two conclusions:

(1) There is just no alternative to self-liquidating credit. That is to say, the production and distribution of consumer goods must be financed through bills of exchange.

(2) There is just no alternative to the gold standard. The regime of irredeemable currency is based on debt. Once adopted, the fast breeder of debt is engaged and will, before long, start spinning out of control.

Solving the problem of the monetary system will also solve the problem of unemployment. Once real bills start circulating, the wage fund will be replenished at once, out of which wages can be paid to all those eager to earn them for work in providing the consumer with goods and services in most urgent demand.

If we want to exorcise the world of the incubus of unemployment with which it has been saddled by greedy governments in making their bank notes legal tender, not only must we return to the international gold standard, but we must also rehabilitate its clearing system, the bill market. In this way the wage fund can also be resurrected. Then, and only then, can the so-called welfare state, paying workers for not working, and farmers for not farming, be dismantled.

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Reference

The author has a course entitled *The Real Bills Doctrine of Adam Smith* that can be accessed at the website: www.professorfekete.com