REAL BILLS: "WAGGON-WAY IN THE AIR"

by Antal E. Fekete,
Professor, Intermountain Institute for Science and Applied Mathematics, Missoula, Montana, USA.
August 7, 2006

Dear Mr. Princeton:

Thank you for writing. You ask me to comment on the article *Real Bills, Phony Wealth--Financing Is not Funding* (www.lewrockwell.com), May 31, 2006. You also want to know how I would respond to the author's remark in a private communication to you that "one of the problems with Fekete's writings is that he does not distinguish between real bills--which are quite benign--and the Real Bills Doctrine (RBD), which is false and pernicious". I comply with your request with some reluctance as I am not in the habit of returning the ball to the court of mud-slingers.

A paper by the noted monetary economist Richard Timberlake also talks about ". . . the twist . . . that makes the ordinarily harmless real bills into the RBD [is] an advised policy for gearing the creation of new money to the money-value of new goods and services. What could be cooler? . . . As a principle for a commercial bank's lending operations, [the RBD is just as] harmless; but as a theory for central bank monetary policy, it is disastrous." Timberlake's paper gave me the final push to return to this topic once more. Hence is this answer to your kind letter.

"Daedalian wings"

The common earmark of latter-day detractors of the RBD is that they treat Adam Smith as a 'non-person'. They just don't want to acknowledge that he is the father of the RBD. I can well understand their hesitation. It is a forbidding task to get into an argument with this giant of economic thought. I am happy to interpret *The Wealth of Nations* for their benefit. What they call 'false', 'pernicious', and 'disastrous', comes straight from this fountainhead. In explaining the operation of the bill market, Adam Smith describes the circulation of real bills as a "waggon-way in the air". He compares it with the circulation of gold coins in moving merchandise to the final consumer, which is like an earthly waggon-way winding through agricultural land, as it were. Land that had to be taken out of production. Land that cannot be turned "into good pastures and corn fields . . . to increase very considerably the annual produce of land and labor". Moreover, since the road from the producer to the consumer is getting ever more roundabout (as the the productivity of labor and capital increases), the amount of agricultural land taken out of production also increases by leaps and bounds with no end in sight. Therein lies a problem. We may end up with more land dedicated to waggon-ways, and less to growing produce. Either there is a limit to further increases in productivity, or the fruits of higher productivity will be gobbled up by doctrinaire insistence on a "100 percent gold standard".

The solution? As Adam Smith suggests, the "invisible hand" of the market has created a "waggon-way in the air". It has let circulating capital be financed through real bills, thus freeing up a large part of agricultural land which could then be put back into production. It has also stopped further incursions of productive land. The true meaning of Adam Smith's simile is that gold can be put to better use in financing fixed rather than circulating capital. Bills drawn on merchandise in urgent demand have "Daedalian wings". The reference is to the Athenian inventor Daedalus who, according to mythology, fashioned feathers, reeds, wax, and twine into wings for himself and for his son Icarus, in order to escape from the island of Crete where they were held against their wish. With the aid of those wings bills can fly under their own steam. It is true that bills arising out

of the financing of fixed capital, for example: capital needed for further refinement in the division of labor, or for further perfecting the roundabout ways of production processes, won't fly (read: will refuse to circulate). Only bills financing circulating capital (that is, the movement of finished or semi-finished goods moving from the producer to the consumer) may. It is also true that every new division of labor, and every new twist in the roundaboutness of production, brings with it new demands for additional circulating capital. The point is that this would not take gold coins out of circulation, as it would in the absence of a waggon-way in the air.

Besides observing that real bills do fly we may add that fly they must sufficiently fast so that the goods will reach the ultimate gold-paying customer in less than 91 days. This number, 13x7, is not taken from cabal for reasons of being lucky. It is just the length of the seasons of the year. Clearly, the type of merchandise demanded most urgently by the consumers changes with the seasons.

Interestingly, Adam Smith makes an apology to his readers of 1776 for having recourse to "such a violent metaphor" as the "waggon-way in the air" and the "Daedalian wings of paper money [secured by real bills]". No apology is necessary to readers of *The Wealth of Nations* 230 years later. New-Yorkers, and dwellers of other North-American cities are well used to enjoying seedless grapes picked on the sunny slopes of the Andes the day before, air-lifted to them via a waggon-way in the air, literally, in cargo jets, through several thousands of miles. Grape harvest in the middle of winter! This is something that even Adam Smith's vivid imagination might not fathom. If latter-day detractors of the RBD in the 21st century are unable to follow the reasoning in *The Wealth of Nations*, it cannot be blamed on Adam Smith's use of 'violent metaphors'. Could it, perhaps, be due to the obtuseness of the reader?

Adventures of Robinson Crusoe on the Island of Manhattan

The ocean liner *Titanic* hit an iceberg off the coast of Newfoundland, and went down, in April, 1912. Survivors were taken by the freighter *Carpathia* to New York. Among them was one Robinson Crusoe, himself no stranger to shipwrecks. He was determined to put his survivalist tool-box to good use in telling the natives, apparently trapped and waiting to be rescued from the overcrowded Manhattan Island, how saving in the form of a subsistence fund would help them survive better. He saw a lot of paper-pushing on the island. Was this paper part of the subsistence fund? People's face went blank when he started telling them about the virtues of a renewal fund. He picked up a can of sardines in the grocery store and, showing people his torn coat, he proudly announced that he would eat the fish he bought with his savings while he was mending his garment. He thought this would motivate the natives to see the necessity of putting something into the renewal fund for a rainy day.

At that point a kindly economist pulled Crusoe away from the curious crowd and patiently explained it to him that on *this* island the distinction to be made was not between a subsistence and a renewal fund, but between circulating capital and fixed capital. People don't save because they plan to take time off from work in order to mend the fishing net or their garment. They save to pay for the education of their children, and for an old-age nest-egg. They may also save to accumulate capital, if they want to quit the labor force and become their own boss in their own business. In either case the purpose for saving is divorced from productive endeavor.

Circulating capital in the form of paper-pushing was what "could be seen". What "could not be seen" was the underlying goods moving in the opposite direction in the bottoms of vessels moored in the harbor.

The survivalist instinct in Crusoe made him to accept the explanation of the economist, and he settled down to learn the new paradigm. He realized that there are islands and islands, and the economics applicable to one may not be applicable to the other.

The Principle of Clearing

I use an example of Ludwig von Mises to demonstrate that real bills involve neither funding nor financing. They involve the Principle of Clearing which states that each tradesman is paid for value added, *after the sale of the finished product*, from the proceeds.

The spinner is spinning cotton and wool into yarn that he delivers to the weaver who, in turn, weaves the yarn into cloth to be delivered to the clothier. The latter runs a store selling the cloth to the ultimate cash-paying consumer. Following merchant custom, the weaver does not expect to be paid in cash at the time of the delivery of cloth (a good of the first order). So he bills the clothier for the cloth delivered, who endorses the bill in writing across its face: "I accept". The bill stays with the weaver. When the spinner delivers the next consignment of yarn (a good of the second order), the weaver endorses the bill drawn on the clothier on the back and passes it on to the spinner (adjustment may be made in coin.) The bill is now in the possession of the spinner who keeps it as evidence of receivables pending settlement in less than 91 days, by which time the consumer will have bought the underlying first-order good, and the wherewithal for payment will be on hand.

Note the saving: the pool of circulating gold coins did not have to be invaded twice in making payment for the maturing good. It did not have to be invaded even once. The gold coin of the consumer was given up voluntarily and was available to do the job of clearing. Of course, the saving would be even greater if the production process was more roundabout. The single gold coin given up by the final consumer would liquidate all the claims, whether the production process had four, fourteen, or forty stages.

"Neither a borrower, nor a lender be" (*Shakespeare*)

It is important to see that the spinner is not a lender, and the weaver is not a borrower. *No funding and no financing is involved*. The bill is not a collateral security. It is simply a receipt for goods of a stated quantity and quality that has been delivered. It evidences receivables. The face value of the bill is payable on settlement day. The usual term is "three months net". Tradesmen follow a long-established merchant custom in allowing for the time it takes to sell the underlying merchandise. Producers of semi-finished goods never (make that "hardly ever") quote or charge cash prices. They quote and charge *discounted* prices, payable at a later date specified on the face of the bill.

One day the banker calls on the spinner. He offers to purchase (he uses the word "to discount") maturing bills in his possession. The banker explains that he will shoulder the cost and the burden of collection at maturity. In the meantime the spinner can put the cash to immediate use. The spinner cannot resist the temptation. He endorses the bills on the back, thereby transferring his rights to the banker. Again, it is important to see that there is no lending or borrowing involved, nor is financing or funding. None of the previous arrangements has been disturbed by the transfer. The banker's role here is active rather than passive: he goes out and acquires an earning asset. It is incorrect to say that the banker has "monetized" the bills. If anything, it is the market, or the "invisible hand" of which Adam Smith spoke, that has imparted ephemeral monetary privileges to the bill. These privileges lapse at the moment the bill matures. The banker's role is that of the midwife.

The weaver could have sold the bill drawn on the clothier to another tradesman, say the loom-maker. Even tradesmen who do not know the clothier in person would accept bills drawn him, or on any other merchant selling first-order goods for that matter, in payment for semi-finished goods. Nobody needs to worry that the clothier might default. In the unlikely event that the clothier has to take a loss, he would still pay the face value of the bill at maturity lest he be denied discounting privileges in the future.

No funding, no financing

In summary, no funding or financing is involved in real bill circulation. Its dynamics is based on a different principle, other than that of combining capital and labor. The principle involved is that the value of a product may be greater than the sum total of the values of its component parts. Take, for example, pottery, the mainstay of trade in antiquity. Chief ingredients are: clay and fire. Clay is basically mud, representing little or no value. Fire is as common as water with no commercial value. But when put together, you have pottery which is in high demand. Because of this sudden, not to say miraculous, increase in commercial value, no financing or funding is needed to move the product. It would self-finance its own journey from the producer to the consumer.

The Bill of Exchange Saga

Thus, then, did the saga of the bill of exchange replacing gold coin circulation begin.

There was no government coercion, no bank intrigues involved. Everything was done spontaneously and voluntarily. This clearing system worked perfectly and without a hitch for hundreds of years, before central banks were imposed on the people by spendthrift governments that were anxious to discount their own bills, too. They found to their chagrin that "anticipation bills" just wouldn't fly. They needed the assistance of a central bank to shelter their bills in the bank's portfolio against "the slings and arrows of outrageous fortune". Treasury bills, along with "accommodation bills", "pig-on-pork bills" or any other phony bills that could not face the scrutiny and the ravages of the bill market had to be sheltered. It was at this point, it may be noted, that periodic runs on banks (not excluding the central banks) have started.

Discount rate *versus* interest rate

The banker applied a "discount" to the face value of the maturing bill when he purchased it from the producer. The discount was equal to the number of days to maturity times the "discount rate". It is of utmost importance to distinguish the discount rate from the rate of interest. The former is always the lower of the two. Moreover, the discount rate tends to be low if consumer confidence is high, and high if consumer confidence is low. In other words, the discount rate varies inversely with the *propensity to consume*. By contrast, the interest rate varies inversely with the *propensity to save*. It is unfortunate that Mises has failed to recognize this difference which makes his theory of interest faulty. Several other errors can be traced to this fundamental mistake. For example, Mises said that a promise to pay gold on demand can substitute gold in every market where the maturity and security of the promise is recognized. Not so. The marginal bondholder would act contrary to purpose if he accepted a promise when he sold his gold bond in protest against low interest rates: he would take zero return in exchange for a positive one. Mises also held that paper currency, whether redeemable or not, is a *present good* rather than a future good. As far as it is known he has never commented on the question how this is reconciled with the fact that the government is ready to helicopter-drop any amount of it as it sees fit. Was Keynes right after all in suggesting that the government can turn stone into bread?

The discount rate makes the real bill an *appreciating asset.* Its value increases with the passing of every day, right up to maturity. This is why the real bill is in constant demand. In fact, real bills are the *most liquid earning asset that the bank can have*, second only to gold (not considered an earning asset). To discount a real bill is not a *lending* function of the bank. It is a *clearing* function. The bank could never get into trouble on account of its clearing, although it can on account of its lending activities. This has important consequences. The borrower must invade the pool of circulating gold coins and withdraw an equivalent amount to repay the loan at maturity. If too many loans mature at the same time, there is a problem. Some borrowers may find it difficult or impossible to withdraw gold, and defaults may cascade. *It is not the contraction of the money supply that causes prices to fall, but the financing of circulating capital through bank loans rather*

than real bills. As far as the clearing function of the bank is concerned, such an outcome is unthinkable. The real bill is a *self-liquidating paper*. The obligation is liquidated with the gold coin of the final consumer, not with a gold coin withdrawn from circulation by the borrower. It is a constant source of amazement for me why detractors of the RBD are unable to understand such a simple yet fundamental distinction, one that was so clearly explained by Adam Smith 230 years ago.

The death of Icarus

Icarus was so thrilled with their flight that, ignoring his father's admonition, he was flying ever higher and ever closer to the Sun. The heat eventually melted the wax, his wings came unstuck, and Icarus plunged to his death in the Aegian Sea. Detractors of the RBD gleefully point out that this is exactly what happened to the U.S. economy in 1933 suspended, as it was, on the Daedalian wings of the RBD -- due to the misguided monetary policies of the Federal Reserve.

What these detractors forget is that it was not faulty Daedalian wings, but the disobedience of Icarus that caused the tragedy. The RDB was made non-operational in violation of the law. The practice of "open market operations", euphemism for organizing the public debt into currency, was a further incursion of the law. Note that the ownership of government bonds was not made illegal by the Federal Reserve Act of 1913, only the monetization of it, that is to say, the practice of paying for the bonds with Federal Reserve notes or deposits *created out of nothing* for this purpose. The Federal Reserve banks were free to acquire the government bond in any other way, e.g., through buying it with gold. Furthermore, note that member banks were left free to monetize government bonds -- a serious loophole that corrupt Federal Reserve officials were quick to exploit. When the unlawful inflationary monetary policy of the Federal Reserve caused a bubble in the government bond market, making bond prices collapse in 1921; the Florida real estate bubble, making real estate prices collapse in 1924; and the stock market bubble, making share prices collapse in 1929, Federal Reserve monetary policy made an "about-face", returning to the guidelines of the RBD as they were required to do according to the law as it then stood. It was too late: the Great Contraction of 1929-1933 could not be averted.

But the Great Depression of 1933-1941 could have. However, just when the economy made the first tentative steps to recovery, something terrible happened. The gold standard, and with it the RBD, fell victim to sabotage. On March 4, 1933, the day that "shall live in infamy", the newly inaugurated president of the United States took the law, and the Constitution, into his hands. He called in the gold coin of the realm so that later, after the citizenry has complied with his passionate appeal to patriotism, he could cry down the value of paper money that had been paid out "in compensation" for the confiscated gold. Enriching the government through defrauding the citizenry was bad enough. The appeal to patriotism made it a hundred times worse. As gold coin circulation is an absolute prerequisite for the RBD, no wonder that the Daedalian wings melted, waggons in the air were derailed, and the U.S. economy plunged. As it did, it took the world economy with it.

It was no coincidence that the beginning of the Great Depression coincided with the sequestration of gold. *And that is the true story of the death of Icarus*.

Yours, etc.,
AEF