

## REAL BILLS AND GOLD

The Daily Bell published an interview with Dr. Lawrence H. White, Professor of Economics, George Mason University, on October 24, 2010. One of the questions the interviewer asked was this: “Please comment on real bills and how they work.”

In his answer Professor White gave the following example. Joe the Baker buys flour from Bob the Miller and gives him a bill promising to pay \$1000 in 90 days.

¶ 1. There are several problems with this description. In actual fact it is not Joe who issues the bill but Bob. The bill is *drawn* by Bob on Joe who must *accept* it before it can have any value. In common parlance Bob bills Joe. Professor White puts the cart before the horse in confusing the concept of a *bill* with that of a *note*. A bill originates with the *payee*, the note originates with the *payer*. This is no hair-splitting. The difference is important. A note is evidence of *debt*. A bill is evidence of *value to be added*. There is no loan, no lending and no borrowing involved in Joe’s purchase and Bob’s sale of the flour. None whatever. The transaction cannot be understood except in the context of merchandise maturing into the gold coin that only the ultimate consumer can release — a process that makes the relationship between Joe and Bob one of coordination rather than one of subordination. If anything, Bob could be considered the subordinate. Joe is one step closer to the boss, the consumer, and he is the one to get the gold coin first. He dispenses bread that is in *general* demand. Everybody eats bread. Flour that Bob dispenses is only in *special* demand. It is not as “liquid” as bread, if liquidity of (finished or semifinished) products is defined by how far removed from the consumer’s gold coin they are.

It is preposterous to suggest that Bob is the lender and Joe is the borrower. The two men are partners in a joint enterprise, made *ad hoc*, in order to provide the consumer with bread. Their role is like that of the two blades of a pair of scissors: neither can do the job by itself. This is not to deny that Bob extends credit to Joe. But extending credit *is not the same as lending*. To suggest that Joe is in debt to Bob as a result of borrowing is entirely fallacious. Joe is in a very strong position: the bill he has accepted *can circulate as money* for 90 days. The note of a mere borrower cannot.

¶ 2. Professor White goes on to say that Bob the Miller can either wait 90 days for his money, or he can go to a bank and sell his bill. The banker will pay Bob something less than \$1000 because he takes interest due for 90 days out of the proceeds.

Again, there are several problems with this description. The main one is the suggestion that banks are necessary for real bills to be effective and useful. This representation makes facts stand on their head. The question whether bills came first or banks is not a “chicken or egg” problem. We have the facts certified by Ludwig von Mises, no friend of the Real Bills Doctrine, that bills did. Moreover, we have it on the authority of Adam Smith that real bills do circulate as money on their own wings and under their own steam. By contrast, legal tender bank *notes* circulate by virtue of the strong arm of the government.

It would have been more correct for Professor White to say that Bob, if he wanted cash (read: gold coins) immediately, then he would go to the bill market and *discount* his bill (read: exchange it for gold coins at a price discounted by the number of days remaining to maturity, at the prevailing discount rate). But the beauty of real bills is seen in the fact that if all Bob wants to do is to pay for the shipment of grain that is being unloaded at his mill, then he does

not have to go to the bill market to get gold. He can simply endorse the bill drawn on Joe, and Dick the Grain Merchant will be glad to take it in payment of the grain.

I repeat: the \$1000 face value of the bill does not represent debt and the discount does not represent interest on debt. Rather, it represents value to be added to the underlying merchandise and it is incumbent upon Joe the Baker to accomplish this feat. Time preference has nothing to do with it. The height of the discount rate is governed by considerations entirely different from those governing the height of the rate of interest, as we shall presently see. Confusing the two rates is the worst mistake economists have ever made, and are still making.

¶ 3. Professor White condescendingly admits that bills, while they were still tolerated, used to command a low interest rate because of their “low default-risk”. This remark confuses the issue further. Risk of default has nothing to do with the height of the discount rate which is *not* determined on a case-by-case basis but, rather, across the board. In fact the risk of default is so low that it can be taken to be zero. I ask you: how many bakers go bankrupt for each banker that does?

To understand what determines the height of the discount rate, as opposed to that of the rate of interest, we have to go not to the saver but to the consumer. The height of the discount rate is determined, not by the *propensity to save*, but by the *propensity to consume*. In more details, the discount rate varies inversely with the propensity to consume (whereas the rate of interest varies inversely with the propensity to save).

A higher propensity to consume means that Joe the Baker experiences increased cash-flow (really, an increased flow of gold coins). It prompts him to get rid of the gold coins by prepaying his bill outstanding. Rather than buying back the bill he has accepted, which may have been endorsed and passed on a dozen times and would be next to impossible to track down, he simply goes into the bill market and buys *any* bill with three good signatures. The demand for bills has thus increased, making the bill price rise. This means that the discount rate is *lower* as a direct result of an increase in the propensity to consume. Conversely, a decline in the propensity to consume decreases demand in the bill market as retail merchants have a reduced cash flow and fewer gold coins to get rid of in prepaying their bills outstanding. Decreased demand shows up as a lower bill price or, what is the same, a *higher* discount rate.

Our argument clearly shows that the credit represented by real bills has absolutely nothing to do with the propensity to save. The source of commercial credit is not *savings*, it is *consumption*.

The reason why real bills have been and are badly misunderstood by most students of credit is a poor understanding of gold itself, and the “next best thing” to gold. Undoubtedly, the next best thing to gold is the bill of exchange representing merchandise in most urgent demand that is moving apace to the ultimate gold-paying consumer, and will be purchased by him before the season of the year changes (causing fundamental changes in the character of consumer demand) that is, in not more than 90 days. The process of supplying the consumer is a *maturation* process of merchandise which we figuratively describe as the maturing of the real bill into gold coins.

The consumer is fickle, and changes in his taste are unpredictable (to say nothing of *hers*). The army of merchants and producers must stand on their toes to serve consumer demand efficiently and instantaneously. It is the gold coin that makes the consumer king. If you removed gold coins from circulation, as European governments started doing exactly 100 years ago, then merchants and producers would start serving another sovereign. From then on, they would rather serve the issuer of “legal tender” bank notes. This change in the person of the sovereign corrupted the economy and caused an upheaval in the Wealth of Nations.

¶ 4. Professor White says that “real bills were an important source of business credit in the 19<sup>th</sup> century, and a major category of assets in a typical bank portfolio.” This sounds as if our grandfathers lived in backwater unmindful that there are other, more appropriate sources of commercial credit. The fact is that it was not progress or enlightened thinking but, rather, lust for power, desire to conquer, chicanery, malice, and vindictiveness on the part of certain governments that eliminated real bill circulation.

Two dates stand out. (1) In 1909 first the French government and then, hard on its heels, the imperial German government introduced legislation making the note issue of their central banks legal tender. This paved the way towards financing the coming war with credits. (2) In 1918 the victorious Entente powers decided to block a spontaneous return of real bill circulation for they were afraid of multilateral trade. They would have liked to continue the wartime blockade of Germany. As there is no such a thing as peacetime blockade, they had to settle for something less: replacing *blockade* with *blocking* (real bills circulation, that is). This meant replacing *multilateral* with *bilateral* trade. Or, to call a spade a spade, replacing *indirect* with *direct* exchange *alias* barter — a relapse to conditions prevailing during the Stone Age. Through bilateral trade they hoped to monitor and, if need be, control German imports and exports. Under multilateral trade monitoring would be more difficult if not impossible.

The collapse of the international gold standard was the direct consequence of this malicious and vindictive decision. The gold standard could not survive the destruction of its clearing house: the bill market — its most vital organ.

The world is still suffering the consequences. “Structural unemployment” was perfectly unknown while real bills were financing multilateral trade. The elimination of real bill circulation has destroyed the *wage fund* out of which the wages of workers producing consumer goods can be *prepaid*. Prepaid, to be sure, because the ultimate consumer’s gold coin may not be available to pay wages for up to 90 days. However, the pay envelope must come weekly, rather than quarterly so that the Lord can “give us our daily bread”. Thus, in a real sense, the Lord’s Prayer is also a prayer for a speedy return of real bills circulation.

Structural unemployment, plus periodic outbursts of a horrendous tide of unemployment was the result of the destruction of the wage fund. The 1930 episode was blamed on the gold standard. This argument has been exploded by events during the present GFC which, in the fullness of times, will be far worse as far as unemployment is concerned than the earlier episode. Real bill circulation has been eliminated along with the gold standard, yet unemployment is still with us. And, curiously, no one is inquiring how it can be that the removal of these two arch-enemies of government omnipotence has *not* removed the threat of deflation, depression, and unemployment — as promised by Keynes and other false prophets.

I shall continue my comments with a concluding article entitled *More Real Bill Fallacies*.