

MORE REAL BILL FALLACIES

In the first article of my two-part series on the Real Bills Doctrine (RBD), in commenting on the Daily Bell's interview with Professor Lawrence H. White on October 10, 2010, I made the central point that the source of commercial credit is not *saving* but *consumption*. The following example will dramatize this point. Assume for the sake of argument that *all* banks in the whole wide world succumb to the sudden death syndrome simultaneously. What does this mean in terms of the production and distribution of consumer goods? Would we have to go back and start from scratch to save in order to replenish society's circulating capital? Saving is a time-consuming process and people have to get fed, clad, shod, and sheltered in the meantime. We could *not* restore circulating capital through saving for the simple reason that before we could we would die of starvation.

Luckily, there is no need to go through such a regimen to satisfy the dogma that the only source of capital is saving. Consumption *per se* is a ready and instantaneous source of commercial credit. Real bills drawn on merchandise *in most urgent demand* will supply all the credit society needs so that consumption can continue without interruption — and the banks be damned. It does not matter if very little gold is available to pay the bills upon maturity. My detractors' 100 percent reserve banking would be confronted with sky-high prices on account of the scarcity of gold. Under the RBD prices need not be high: the burden of adjustment would not on prices, as the quantity theory of money falsely teaches; it would fall upon the discount rate. There is only one interdiction, namely, real bills *must not mature in mere promises to pay gold* — the proviso of Ludwig von Mises notwithstanding that “claims to gold are a *complete* substitute for gold in markets where their security and maturity of those claims is recognized.” (*The Theory of Money and Credit*, Chapter 15.) Claims to gold at maturity are useless as payment for the bill at maturity. A note promising gold is *inferior* to the bill. The bill *must* mature into something *superior*. The only thing superior to a real bill drawn on consumer goods in most urgent demand is the gold coin. A bill maturing in a mere claim on gold *will not circulate*.

In commenting on the first part of this paper several of my correspondents asked why the discount rate is getting *lower* when the bill price is getting *higher*. Here is the relevant arithmetic. Suppose a bill of \$1000 maturing in 91 days (or 0.25 years) circulates at \$990. This corresponds to a discount rate of 4 percent per annum, because $1000(1 - 4(0.25)/100) = 10(99) = 990$. If next day the bill market quotes the same bill at a higher price, say at \$995, then there is a corresponding *decrease* in the discount to \$5, half of the earlier discount of \$10. Thus the discount rate has fallen from 4 to 2 percent.

Let us return to the Daily Bell's interview with Professor White. Observing that the RBD has been important in the history of monetary theory, he goes on to say: It is a mistaken idea that if the banking system lends only by discounting real bills, then it cannot over-expand. It is also a dangerous idea ... because rather than letting interest rates rise to reach their new equilibrium level whenever the business demand for credit rises, the banks will actually make money over-expand.

This is tantamount to blaming the loot, rather than the thief, for the thievery. Why did it allow itself to be stolen? There are *uses* and *abuses* of credit. Over-extension of credit is an abuse. For example, drawing two or more bills on the *same* merchandise is an abuse, and so is rolling over a bill at maturity rather than paying it, regardless whether or not the underlying merchandise has been sold. Such abuses should be dealt with by the Criminal Code in the same breath as dealing with the forgery of bank notes.

Professor White's remark assumes that the discount rate is the same as the short term rate of interest. I shall not pause here to repeat the arguments of my previous article refuting this misconception. Instead, I shall describe what has actually happened when banks first put in an appearance to take a piece of the action in the already flourishing bill market.

Banks have arisen because they had a legitimate and useful role to play: (1) Their credit has a high name-recognition; (2) Bank credit in the form of bank notes come in standard denomination which is easy to count and make payments with.

The banks in discounting real bills paid with bank notes of their own issue. Thus they substituted their own credit, enjoying high name-recognition, for the sometimes obscure credit of traders in the periphery. Also, they offered standard-denomination bank notes to replace bills with odd amounts as face value that circulated more easily. Because of this, bank notes were welcome: you did not have to scrutinize the credit standing of the drawer and the drawee of the bill. People were glad to pay for this service in the form of foregone discount which accrued to the bank for facilitating the circulation of real bills further.

The *good* banks strictly followed the market rate of discount. Upon the expiry of the underlying bill they punctiliously withdrew a corresponding amount of bank notes from circulation. There is no sense in which the reserves of these banks could be called "fractional." Bank liabilities were backed 100 percent by reserves, either in the form of gold, or the next best thing to gold: real bills maturing into gold in 91 days or less. Such banks were not exposed to the nemesis of poorly managed banks: the bank run. Every business day on the average as much $1\frac{2}{3}$ percent their portfolio of real bills matured into gold coins. That was sufficient to meet normal demand for gold coins. If the demand for the gold coin was abnormally high, then the banks had to go to the bill market and sell unexpired bills from portfolio for gold, in order to meet the extra demand. There was no problem involved in selling real bills for gold. Some other banks experiencing an overflow of gold coins would be scrambling to get earning assets and would buy the extra supply of real bills eagerly. To call these "fractional reserve banks" is to bark up on the wrong tree.

However, inevitably, there were *bad* banks as well that did not bother withdrawing their bank notes from circulation when the underlying bills expired but made fresh loans with them on which they collected interest. This was very profitable business for them. Nevertheless, their profits were illegitimate and their loans were fraudulent. In effect, the bad banks were borrowing short in order to lend long. I call such a transaction *illegitimate arbitrage* between the bill market and the loan market, to take advantage of the spread between the higher interest rate and the lower discount rate. Illegitimate arbitrage is unsound because the short leg of the arbitrage has to be moved forward every quarter and it may not be possible to do at the old rate. The new discount rate may well be higher, and if it is higher than the interest rate on the long leg, then the bank ends up with a loss rather than a profit. In addition, the bank is guilty of false pretenses. It pretends that its bank notes are covered by real bills drawn on fast moving merchandise demanded most urgently by the consumers — which could circulate on their own in the bill market. In reality, however, its notes were covered by *anticipation bills* and *accommodation bills* or notes of debtors — that could not so circulate. Illiquid and dubious paper: expired real bills on unsold or unsalable merchandise; accommodation bills drawn on the dreams of lunatics, notes of speculators was being aided and abetted by the fraudulent bank that gave shelter to them in its portfolio that was not open for public inspection. Note the difference: bills circulating in the bill market are completely transparent making fraud and conspiracy easy to detect. The common earmark of bad banks is that their assets cannot be readily sold except maybe at a loss.

I have mentioned the notes of speculators that are ineligible to figure among the assets of banks. This is no condemnation of speculation *per se*. Speculators in agricultural commodities render a great service to society. Trouble starts when they speculate with other

people's money without their knowledge and concurrence. The best example of this is the conspiracy committed by Dick the Grain Merchant and Bob the Miller who anticipate an increase in grain prices from which they want to benefit. Lacking money of their own to buy grain, they decide to put Dick-on-Bob bills into circulation drawn on grain the movement of which has been arrested. This conspiracy is criminal: the bill market *must not be* used to finance speculation. The low discount rate is to benefit the consumer. Luckily, the bill market exposes such conspiracies by virtue of their openness. Trouble starts when the bank is participating in the conspiracy and gives shelter to the fraudulent Dick-on-Bob bills.

It is possible to brand the bad banks "fractional reserve banks" to the extent that a portion of their credit outstanding is not covered by gold coins or real bills maturing into gold coins. The existence of such delinquent banks, however, does not justify disparaging the entire banking system calling it "fractional reserve banking system." The suggestion that in discounting real bills banks created money out of thin air is fanciful and untrue.

The Daily Bell concludes the interview by commending Professor White for "simplifying the Real Bills debate." It adds that "the real bills debate has raged for some time and Professor White's perspective has clarified matters." With due respect to Professor White perspectives, I demur. Far more careful analysis of real bills and the difference between the discount rate and the rate of interest is needed than Professor White is willing to offer. Just as my detractors, Professor White declines to carry on the debate on the premise that the merit or demerit of real bills must be assessed in the context of complete absence of banks, since real bills can and do circulate on their own wings and under their own steam. Such refusal is especially regrettable at the present juncture of an unprecedented world banking crisis. There is a real danger that all the banks may simultaneously succumb to the sudden death syndrome. I imagine that Professor White would not dismiss this assumption of mine as outlandish.

Professor White is one of the important protagonists of the hard money movement. In the interest of success, and also to save the world from unnecessary ordeal and much suffering, we should admit that further study of the RBD is needed, including an impartial inquiry about the circumstances under which governments forcibly blocked real bill circulation at the end of hostilities in World War I, and enforced the ban until the gold standard, such as it was, collapsed. It did collapse because it could not survive the destruction of its clearing house, the bill market, its most vital organ.

It is a fallacy to assume that real bills thankfully faded away for reasons of being obsolete, and to treat the RDB as a stale, "mistaken" and even "dangerous" idea.

The RBD may protect lives.

It may also save our Western civilization.