UNEMPLOYMENT:

Human Sacrifice on the Altar of Mammon

"Revisionist Theory and History of Money"

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September 30, 2005

Abstract

The Great Depression of the 1930s bringing unprecedented world-wide unemployment in its wake was not caused by the “contractionist nature” of the gold standard as alleged by John M. Keynes. Nor was it caused by “fractional reserve banking” as alleged by Murray N. Rothbard. It was caused by national governments sabotaging the clearing system of the international gold standard, the bill market, thereby destroying the wage fund of workers employed in the production and distribution of consumer goods. In throwing out the bath-water of real bills governments have thrown out the baby of full employment. Unemployment is the modern version of the earlier religious practice of making human sacrifice on the altar of Mammon

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 issues 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 stayed in circulation for another five years. It was not the disappearance of gold coins from circulation that heralded the destruction of the world’s monetary and payments system. There was an early warning: the German and French government’s decision to make bank notes legal tender that would effectively sabotage the clearing system of the international gold standard, the bill market.

Real bills drawn on consumer goods in urgent demand circulated world-wide without let or hindrance before 1909. As goods were moving to the ultimate gold-paying consumer, bills drawn on them matured, as it were, into gold coins, that is to say, into a present good. It is readily seen that the notion of a bill maturing into a legal tender bank note is preposterous. The bank note is not a present good but, like the bill itself, a future good. Furthermore, legal tender means coercion enforced within a given jurisdiction but unenforceable outside. At any rate, legal tender bank notes were incompatible with the voluntary system based on the bill of exchange payable in gold coin at maturity. They were bound to paralyze the market in real bills. The monkey wrench has been thrown into the clearing system of the international gold standard.

The bank of issue continued to use the bill of exchange as an earning asset to back the legal tender bank note issue. But other subtle changes would 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 financial 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 the entire portfolio of the bank of issue consisting of real bills exclusively would be replaced by one consisting of financial bills, including treasury bills. The real bill has become an endangered species. In another five years it would become extinct.

Bank notes as self-liquidating credit

Previous to 1909 circulating capital for the production of consumer goods in urgent demand had been financed, not out of savings, but through discounting real bills at a commercial bank which would then rediscount them at the bank of issue that supplied the country with bank notes. To be sure, these bank notes represented self-liquidating credit. They were merely a more convenient form of the bill of exchange from which they derived their strength. They came in standard denomination round figures. Unlike the bill of exchange they could without hassle and loss be broken up into smaller units. The great convenience they offered was valued by the public so much that people were willing to pay for it in the form of forgone discount.

When the bill matured and was paid, the bank note was retired. For this very reason it was not inflationary, not any more than the real bill itself. The bank of issue would under no circumstances prolong credit beyond the maturity date of the rediscounted bill. If the underlying merchandise could not be sold in 91 days then, for the stronger reason, it would not be sold in 365 days, certainly not before the same season of the year came around once more. But by that time the merchandise would be stale and could only be sold at a loss. Prolonging credit on a mature bill would violate the letter and spirit of the law governing central banking in Germany prior to 1909.

Could a commercial bank, nevertheless, roll over a real bill at maturity? On strictly economic grounds it wouldn't. First of all, it would forfeit its rediscounting privileges at the bank of issue if it did. Secondly, it would make its portfolio less liquid and so it could no longer compete successfully with more liquid banks. Having said this, we must admit that in practice some banks may have been guilty of rolling over mature real bills for various reasons. At the benign end of the spectrum the reason could be a false sense of loyalty to clients; at the malignant, conspiracy with them in speculative ventures. It was this latter practice that could be properly condemned as "credit expansion". However, the unethical behavior of some banks should be no grounds for issuing a blanket condemnation of all banks and calling the legitimate practice of discounting real bills "credit expansion" with a disapproving connotation.

Real bills *versus* financial bills

The changeover from bank notes backed by real bills to bank notes backed by financial bills was the last nail in the coffin of the clearing system of the international gold standard. Monetary scientists and others with intellectual power to grasp the intricacies of bank note circulation raised their voice condemning the new paradigm making financial bills eligible for rediscount, a practice that had previously been prohibited by law with severe penalties for non-compliance. Most people could not understand what the fuss was about. But there was a world of a difference between rediscounting real bills as opposed to financial bills. It was the difference between self-liquidating credit and non-self-liquidating credit. Real bills were backed by a huge international bill market with its practically inexhaustible demand for liquid earning assets. Financial bills were backed by the odds that speculative inventory of goods and equities or investment in brick and mortar may be unwound without a loss. If the odds did not play out in time, then at maturity the financial bills would have to be rolled over. This was borrowing short and lending long through the back door, carrier of the seeds of self-destruction.

The chimera of "fractional reserve banking"

Financial bills made the asset portfolio of the bank of issue illiquid. The bank could no longer satisfy potential demand for gold coins, should holders of bank notes decide to exercise their legal right to redeem them. To take away this right was the reason for making bank notes legal

tender in the first place. Redemption wouldn't be a problem as long as the asset portfolio consisted of real bills exclusively. Every single day one-ninetieth of the outstanding bank notes matured into gold coins which were available for redemption. This would normally suffice to satisfy daily demand. But what about abnormal demand for gold coins?

A real bill is the most liquid earning asset in existence. 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. The bank of issue would not have the slightest difficulty to get gold in exchange for real bills in the international bill market. Once upon a time the Bank of England boasted that "it could draw gold from the moon by raising the rediscount rate to 5%." 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 warm and sheltered tomorrow and every day thereafter.

This explodes the blanket condemnation of "fractional reserve banking", a stand so popular nowadays in some circles. Detractors of fractional reserve banking are barking up the wrong tree. They should condemn the practice of rediscounting financial bills on the same terms as real bills. The latter were self-liquidating, while the former had impaired liquidity: under certain circumstances they might become unsaleable even in peacetime. They were simply unsuitable to serve as bank reserves.

Prior to 1909 the charter of every bank of issue explicitly made financial bills ineligible for rediscounting. The laws governing central banking prohibited the use of these bills for the purposes of backing the note issue, and prescribed heavy penalties for non-compliance. This was not a controversial issue. Informed people could distinguish between safe banking that utilized real bills and unsafe banking that utilized financial bills to back the note issue. That judgment is epitomized by the old saying that "the easiest profession in the world is that of the banker, provided that he can tell a bill and a mortgage apart".

Reflux

The process of retiring the bank note after the merchandise serving as the basis for its issue has been removed from the market by the ultimate gold-paying consumer is called "reflux". Some authors ridiculed the concept calling it a *deus ex machina*. They argued that the banks were only interested in credit expansion, not in reflux. They would not for one moment think of withdrawing a corresponding amount of bank notes from circulation when the real bill matured. Instead, they would lend them out at interest to enrich themselves at the expense of the public. For the stronger reason, you could also ridicule the entire legal system asking the rhetorical question: "what is the point in making laws when they will be broken anyhow?" This is not a valid argument. You can't judge the merit of an institution by the behavior of those who are set upon destroying it.

Let us follow the trail of gold coins through the path of reflux. Our description is necessarily schematic. For the sake of simplicity we assume that only distributor-on-retailer bills are discounted. This is reasonable as these bills are more liquid than producer-on-distributor bills, or higher-order-producer-on-lower-order-producer bills. We also assume that the retailer is expected to pay his bill with gold coins flowing to him from the consumers. The gold is considered proof that the merchandise underlying the bill has been sold to the ultimate consumer and is not held, contrary to the purpose of bill circulation, in speculative stores in anticipation of a price rise. Finally, our description follows the practice of the German banking system as it was before 1909. The practice elsewhere may have been different, but the essential idea was the same: with the sale of merchandise the gold coin was recycled from the consumer through the retail merchant to the commercial bank, from where it would be withdrawn by producers in order to pay wages, thus putting the gold coin back into the hand of the consumers. Then the cycle of supplying the consumer with urgently demanded merchandise could start all over again.

In more details, as gold coins flowed from the consumer to the retail merchant, they were deposited at the commercial bank. When he was ready to replenish his depleted inventory, the retailer ordered a fresh supply and, after endorsing the bill he returned it to the distributor. The latter would discount it at the commercial bank taking the proceeds in the form of bank notes which the commercial bank obtained from the bank of issue through rediscounting.

The distributor would use the bank notes to pay the producer of first order goods for supplies. The latter would use them to pay the producer of second order goods for supplies, and so on. But when it came to paying wages, all these producers had to draw out gold coins from the commercial bank against bank notes. Upon maturity the commercial bank paid the rediscounted bill with bank notes which the bank of issue was under obligation to retire. It could not lend them out at interest. If it did, it would violate the law, and would have to pay heavy penalties. The only purpose the retired bank notes could be used for was to rediscount fresh bills drawn on new consumer goods moving to the ultimate gold-paying consumer. This was not the same as lending them out at interest, since lending and discounting were two entirely different banking functions.

Now the gold coin was in the hands of the wage-earner. As he spent it in buying consumer goods he enabled the retail merchant to make payments on his discounted bill at the commercial bank with gold. When paid in full, it was returned to the retail merchant and the bill's ephemeral life as a means of payment has come to an end. But the march of gold coins would continue. They would be withdrawn by the producers to pay wages, and the cycle of supplying wage-earners with consumer goods against payment in gold coin could start all over again.

Mistaking the back-seat driver for the boss in the driver seat

The havoc that the silent monetary revolution of 1909 would wreak upon society had not been foreseen. Nor was the causal relation between the expulsion of real bills and massive unemployment recognized in retrospect after the worst happened and almost 50% of trade union members, or 8 million people, lost their jobs in Germany alone.

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. The size of circulating capital 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 generously as to be able to finance all circulating capital that society needed in order to flourish at present levels of comfort and security. To move a $100 item all the way to the consumer may, in an extreme case, require savings in the order of $5000, or 50 times retail value!

Fortunately, there is no need to employ savings in such a wasteful manner. It is true that fixed capital must be financed out of savings. As a result, creation of fixed capital depends on the propensity to save. Not so circulating capital, provided that the merchandise moves fast enough to the ultimate gold-paying consumer. It can be financed through self-liquidating credit which depends on the propensity to consume, but is independent from the propensity to save.

The discovery of this fact is one of the great achievements of the human spirit and intellect, on a par with the discovery of indirect exchange. 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. The detractors of the Real Bills Doctrine have missed one of the most exciting developments of our civilization: the discovery of self-liquidating credit in the wake of the disappearance of risks in the production process as the maturing good gets within earshot of the final gold-paying consumer.

Pari passu with the emergence of the need for consumer goods the means to finance their production and distribution emerges as well. It is in the form of the bill of exchange. Retailers and distributors hardly ever pay cash for supplies of consumer goods. “91 days net” is invariably part of the deal, to give ample time for the merchandise to reach the ultimate gold-paying consumer. Producers of higher-order goods could fold tent and go out of business if they insisted on cash payment for the supplies they provide. Producers of lower-order goods were the boss by virtue of being that much closer to the ultimate consumer and his gold coin. They would laugh you out of court if you told them that they have just been granted a loan and the discount is just interest taken out of the proceeds in advance. They know better. They know that self-liquidating credit is theirs for the taking. They know that the discount rate has nothing to do with the rate of interest. For a consideration they may be willing to prepay their bill before maturity. The privilege is theirs. The discount is just the consideration to tempt them. Those who insist that the producer of the higher-order good is the lender and that of the lower-order good is the borrower are mistaking the back-seat driver for the boss in the driver seat.

The biggest job-destruction ever

Let us now see how the governments destroyed the wage fund of workers employed in the sector providing goods and services to the consumer. These workers’ wages were financed through the trade in real bills. The emerging consumer good they handled would not be sold to the ultimate consumer for 91 days at the latest. Yet in the meantime these workers had to eat, get clad, keep themselves warm and sheltered. If they could, it was only because real bills trading would keep replenishing their wage fund.

In order to create a job capital must be accumulated through savings. This applies to the fixed capital deployed in making both producer goods and consumer goods. In case of the former it applies to circulating capital as well. But if circulating capital had to be accumulated through savings in the latter case, too, then jobs in the consumer goods sector would be few and far in between. In the event jobs were plentiful in that sector because of the fact that circulating capital supporting them could be financed through self-liquidating credit that did not tie up savings. By contrast, jobs in the producers good sector could not be financed in this way, explaining why they were not nearly as plentiful nor as easily available.

When governments locked out real bills from the payments system, they inadvertently destroyed the wage fund of workers employed in the sector providing goods and services for the consumer. Unless they were prepared to assume responsibility for paying wages, there would be unemployment on a massive scale that would spill over to all other sectors as well. Eventually the governments, to avoid undermining social peace, decided to do just that. They invented the so-called “welfare state” paying so-called “unemployment insurance” to people who could have easily found employment had the clearing system of the gold standard, the bill market, been allowed to make a come-back after World War I. What has been hailed as a heroic job-creation program appears, in the present light, as a miserable effort at damage control by the same government that has destroyed those jobs 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 symptoms, the government remove the cause in reinstating the international gold standard and its clearing system, the bill market. They should have demanded that the government abolish the legal tender privilege of bank notes forthwith.

It took 20 years for the chickens of 1909 to come home to roost. But come home they did with a vengeance. However, by 1929 the memory of the 1909 coercive manipulation of bank notes faded, and virtually no one realized that a causal relationship existed between the two events: making bank notes legal tender and the wholesale destruction of jobs twenty years later.

The father of revisionist theory and history of money

One man who did, and whom we salute as the father of revisionist theory and history of money, was Professor Heinrich Rittershausen of Germany. In his 1930 book *Arbeitslosigkeit und Kapitalbildung* (Unemployment and Capital Formation) he predicted not only the imminent collapse of the gold standard but also the wholesale destruction of jobs world-wide as a result of the explosion of the time bomb planted in 1909, wrecking the clearing system of the international gold standard, the bill market. The horrible unemployment Rittershausen predicted would continue to haunt the world for the rest of the 20th century and beyond.

If we want to exorcise the world of the incubus of unemployment with which it has been saddled by greedy governments making bank notes legal tender in their worship of Mammon, 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 fund, out of which wages to all those eager to earn them for work in providing the consumer with goods and services can be paid, will 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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Acknowledgement

The author is grateful to Dr. Theo Megalli of Plattling, Germany, for bringing the work of Heinrich Rittershausen to his attention. The biography of H. Rittershausen (1898-1984) by Dr. Megalli can be found on the website.