

## **BAD-DEBT BASICS: UNSOUND MONEY & BANKING**

The inability of major debtors to meet their debts as contracted has become commonplace during recent years. The phrase "debt crisis" has been applied so often to these situations, which one after another have been dealt with to relieve the immediate threat, there may be a risk the public will be lulled into a false confidence that the U.S. (and world) financial system is being restored to soundness.

To the contrary, the financial and monetary systems are slowly being transformed by debt-crisis management into a far more unsound condition. Whether or not this transformation is a goal of some of the major parties to its evolution, it has received little attention in the popular financial media. To protect its interests the public needs to understand the direction of change and its implications. Monetary analysts, too, may not fully realize the basic source and far-reaching consequences of the ongoing transformation of the U.S. financial and monetary systems.

Some debt-crisis news of the past few months reveals the general approach. One item was the revelation that the Federal Farm Credit System (FFCS), the Nation's single-largest agricultural lender with a reported \$74 billion in credit outstanding, would seek a U.S. Treasury bailout.\* FFCS officials have admitted that some 15 percent (\$11.1 billion) of its loans are uncollectible. Private analysts have

said that the estimate probably is low and, with farmers' problems getting still worse, the uncollectible portion almost surely will rise further. With farmers unable to pay interest and principal on their debts, the FFCS is expected to have large operating losses that, in turn, would leave it unable to pay its obligations.

When the FFCS's financial woes first were publicly admitted in the fall of 1985, FFCS representatives indicated they might seek debt relief for *all* lenders holding part of the \$212 billion total farm debt, including commercial-bank lenders. They reasoned that such a farm-creditors' cartel could be more effective in pressuring Congress for a bailout than could the FFCS alone, or any other single farm creditor by itself. As this is written, we have not seen any reports of joint-action by farm creditors; however, the leadership of the House Agriculture Committee introduced a bill (HR 3792) on November 20 to provide assistance to the FFCS alone.

FFCS officials reportedly had sought a \$6 billion line of credit with the U.S. Treasury, but as originally drafted HR 3792 provided for "only" \$3 billion. Treasury officials opposed even that amount, arguing that the FFCS had a sufficient current surplus and loan-loss reserve funds to sustain itself for some time yet. As submitted, the bill does not mention a dollar amount but rather leaves the matter of financial assistance to the Treasury Secretary.

Yet, HR 3792 provides for the creation of the Farm Credit System Capital Corp. (FCSCC), which would have power to use as it deems necessary the reserves of any of the 37 operating units in order to restructure or liquidate the bad loans of any other arm(s). The FCSCC would become a financial warehouse for the bad loans throughout the FFCS. If the reserves of the system were insufficient, the next plausible step would be for the U.S. Treasury to "buy" some of the FCSCC's assets in order to replenish its funds with which it then

---

\* The FFCS is an independent agency of the Executive branch of the Federal Government. Its stock is owned by its borrowers, who are required to purchase stock of from 5 percent to 10 percent of borrowings. The FFCS has financed most of its loans by selling its own debt securities, which reportedly amount to about \$70 billion outstanding and are widely held. The FFCS consists of 12 regional "banks." Each of these has three operating arms: a land "bank" for farmland loans, an intermediate credit "bank" for short-term production loans, and a "bank" for loans to farm cooperatives. There also is a central "bank" for cooperatives. "Bank" is in quotations because these institutions do not *create* net credit but simply intermediate credit — that is, they borrow and re-lend.

could buy more bad loans of the operating units.

HR 3792 also would modify the powers of the Farm Credit Administration (FCA). Instead of overseeing the management of the FFCS's activities, the FCA would become a quasi-public regulatory agency, like the Federal Deposit Insurance Corporation (FDIC). And like the FDIC, the FCA would have power to force mergers and liquidations of the FFCS's operating units.

### BROADER CENTRAL CONTROL

Another major debt matter surfaced with an announcement that the Federal Home Loan Bank Board (FHLBB) would establish a new subsidiary, the Federal Asset Management Corp., to buy some \$3 billion of bad-debt assets held by the Federal Savings and Loan Insurance Corp. (FSLIC).<sup>\*</sup> The FSLIC had acquired the dubious assets when it paid the depositors of FSLIC-insured savings and loan associations (S&Ls) that failed. With an infusion of \$3 billion in cash, the FSLIC would be in a position to assist in the merger or dissolution of more troubled S&Ls. (Its unobligated funds were reported to be less than \$4 billion recently.)

There evidently are many candidate S&Ls for possible FSLIC rescue. Using "generally accepted accounting principles," which are more realistic than "regulatory accounting principles," FHLBB economists earlier this year reported that 438 Federally insured thrifts with \$107 billion in assets had negative net worths — that is, liabilities exceeded assets. An additional 856 insured thrifts with assets of \$350 billion had net worths between zero and the minimum-required 3 percent of liabilities. To put this number of nearly 1,300 seriously troubled S&Ls in perspective, "only" 800 thrifts either closed or were forced to merge during the entire 5 previous years.

The potential magnitude of the S&Ls' problems and thus of the FSLIC's bad-debt assets and of the prospective Federal Asset Management Corporation's size and requirements for funding have raised the concern of Reagan Administration policymakers. According to one report, the White House Economic Policy Council decided in late November

---

<sup>\*</sup> Like the FFCS, the Federal Home Loan Bank System (FHLBS) is not a direct agency of the U.S. Government, although Federal law in 1932 created it and gave it authority to charter and supervise Federal S&Ls. The FHLBB and the system's 12 regional operating "banks" are owned by its member savings and loan associations. Among other activities, it raises funds (by issuing its own debt instruments) in order to buy assets from its members experiencing temporary liquidity problems. Also like the FFCS, the FHLBS has about \$70 billion of its own debt instruments outstanding. The FSLIC operates under the direction of the FHLBB, although the U.S. law creating the FSLIC gave it authority to borrow directly from the U.S. Treasury.

to try to get the FHLBB to agree to restrictions on the size and scope of the Federal Asset Management Corporation's activities.<sup>†</sup> Administration officials reportedly were concerned that the new corporation would grow rapidly beyond the proposed \$3 billion and issue debt securities that eventually would require a U.S. Treasury bailout.

The third debt item of special interest was Treasury Secretary James Baker's proposal for dealing with the continuing debt crisis of developing countries, especially Latin American countries. The plan calls for the 100 or so largest private bank lenders to 15 troubled-debtor developing countries to provide through 1988 additional credits to those borrowers totaling \$20 billion.<sup>\*\*</sup> Supplementing this sum would be another \$9 billion credit pool (on top of \$18 billion already scheduled) from the World Bank and other multilateral lending institutions. For the poorest African countries, there would be a further special \$2.7 billion credit fund from the multilateral institutions.

There was something to set apart Secretary Baker's proposal from the many other previous debt-rescue plans. Before getting the new credit, the debtor countries would have to agree to adopt policies that placed "increased reliance on the private sector, and less reliance on government to help increase employment, production and efficiency." They also would have to take "actions to mobilize domestic savings and facilitate efficient investment, both domestic and foreign, by means of tax reform, labor market reform and development of financial markets." For encouraging and overseeing the implementation of these policies, Mr. Baker's proposal calls for the International Monetary Fund (IMF) and the World Bank to directly coordinate their activities to this end. That is a significant change, inasmuch as the roles of the IMF and World Bank have been separate and distinct to this time from their creation at Bretton Woods, New Hampshire in 1944. Historically, the IMF's role was to provide short-term credits to governments for temporary balance-of-payments needs, and that of the World Bank was to provide long-term credits for specific economic-development projects that would not be funded from other sources.

With direct coordination of IMF and World Bank policies, the distinctions between temporary financing credits and long-term project credits and between credits to governments and credits to private-sector borrowers become increasingly blurred. Even credit extended by private lenders, such as

---

<sup>†</sup> *The Wall Street Journal*, November 29, 1985.

<sup>\*\*</sup> The 15 countries are Argentina, Brazil, Bolivia, Chile, Colombia, Ecuador, Mexico, Peru, Uruguay, Venezuela, the Ivory Coast, Morocco, Nigeria, the Philippines, and Yugoslavia.

the additional \$20 billion under Sec. Baker's proposal, loses its character as a market-determined flow when made as part of a government-sponsored plan. Private banks with large credits to troubled-debtor countries are given an "out" under such plans. Once they "agree" to participate, they can reasonably argue that regulatory officials cannot hold them accountable to the usual standards of prudent banking. And if the loans should turn out to be completely uncollectible, the bankers can make a plausible case for being bailed out by the U.S. Treasury — that is, by American taxpayers — without harsh penalty.

Felix G. Rohatyn, a senior partner at one of Wall Street's major investment-banking firms (which profit from assisting in the sale of sovereign debt securities) and financial guru of New York City's rescue from bankruptcy, proposed in *The Wall Street Journal* (August 9, 1985) a somewhat similar outline for the rescue of Latin American debtors. Among other things, he recommended "Guarantees provided to the banks, either by their respective central banks or by an international institution such as an expanded World Bank, of all or a portion of the principal amount of the loans in exchange for their long-term stretch-outs and reduction in interest rates. Regulatory and accounting relief to enable the banks to maintain adequate capital ratios and profit performance as part of such a plan. Agreement on the part of recipient countries to open domestic markets to foreign capital with adequate protections. Continued country-by-country, IMF supervision of economic and financial policies."

Not surprisingly, officials of the Latin American debtor countries reportedly are seeking to devise a comprehensive plan for easing their immediate debt burden while still giving them access to additional borrowing. They, too, want more help through multilateral financial agencies in the form of direct loans, guarantees of new private loans, or both. From U.S. bank regulators, they want their commercial-bank lenders to be relieved of presumably prudent regulatory demands for writing-down (and taking book losses on) loans on which the interest rate is negotiated to below-market rates. This would reduce U.S. private bank opposition to negotiating interest rates downward on outstanding Latin American debt. (See box.)

### IMPLICATIONS OF DEBT RESCUES

The most significant common feature of the way today's pervasive domestic and international bad-debt problem is being handled is that the debts are being absorbed by, or coming under the "management" of, larger and larger institutions. A basic economic consequence of this is that the bad-debts

### A TANGLED WEB

A November 14, 1985 *Wall Street Journal* article reported that the banking committee of the American Institute of Certified Public Accountants, the trade group of U.S. private auditing firms, was in a quandary about an impending ruling on the accounting treatment for Argentine government debt securities issued to many U.S. banks as substitutes for loans to private Argentine borrowers. Standard practice would require the banks to carry the debt securities on their books at market value, about 25 percent less than the face value at which the banks received the securities. If forced to recognize the losses, many banks would report sharply reduced profits or even losses. And if the practice were required for Argentine securities, it probably would also have to be applied to those of other Latin American troubled debtors. This would force major U.S. banks to record further, huge losses. Although the standard practice long has been accepted as prudent, the private auditors are concerned that U.S. regulators may overrule a decision requiring the writedown of the assets in question. The accountants' quandary: They have a responsibility to stockholders to accurately assess bank assets; yet, they are pressured by officials not to question the value of foreign loans because it would reduce banks' willingness to extend additional credits to troubled debtors under the Treasury's rescue plan. In plain terms, U.S. regulators want the accounting profession to participate with them in a scheme to falsify the financial statements of the biggest U.S. banks. This is just one more sorry example of the failure of regulators not only to protect the public interest but actually to undermine it to the immediate benefit of the big banks. Smaller banks and those that followed more prudent loan practices also would be competitively disadvantaged.

do not have to be written off and the underlying assets do not have to be sold. This blocks adjustment of relative prices and of all the related output, income, and consumption changes. To illustrate, if the land backing much of the uncollectible farmland loans were forced onto the market, farmland prices surely would plunge and that would change the return available to subsequent owner-farmers. In foreign countries, the forced transfer of assets might put them under more efficient management.\* In the absence of political interference — domestic or international — these appropriate economic changes would not be delayed.

The willingness and ability of officials (elected and appointed) to devise ever-more encompassing schemes for preventing major bankruptcies also indicate that today's debt crisis will not lead to a 1930's-type depression-deflation. Whether the troubled debtor is a major nonfinancial firm (Chrysler), a major bank (Continental Illinois), an entire economic sector (agriculture and agricultural lenders), quasi-government deposit-guaranteeing agen-

\* See "On Being A Debtor Nation," *Research Reports*, October 7, 1985.

cies (the FSLIC and FDIC), multilateral financial institutions (the IMF), and even entire countries and continents (African and Latin American countries), the need to pay obligations when due out of insufficient available assets can be delayed virtually indefinitely. Debtors' appeals to ever-larger institutions and ever-higher authorities with power to command additional *monetary* credit has no external limit under a fiat money regime.

Ultimately Congress has the power to grant fiat-dollar credit in any amount it chooses. Thus far when Congress (or its agencies and the Federal Reserve System) has been confronted with the choice either of letting a big debtor fail (with the possible consequence that depositors would not be fully paid) or of providing a mechanism for granting more credit to the debtor or deposit-insuring agency, there has been no doubt that more credit would be forthcoming. In the absence of depositors' taking losses, the domestic money supply is not reduced (and deflating does not occur) when bad-debtors — even deposit-taking institutions — are rescued or are forced to close.

### OVERRIDING THE MARKET

The handling of the debt crisis by recourse to ever-larger institutions and higher authorities also is resulting in greater centralization of economic decision-making and power. If quasi-government agencies, multilateral-government institutions, or sovereign governments themselves come to the "rescue" of debtors, political strings inevitably are attached to the credits. The strings will be defended, and with some merit (as in the case of Secretary Baker's recent proposal), as essential for guarding against a repetition of similar unsound practices and for protecting the credit-granting institutions' or public's interest.

To illustrate, Federal Reserve Board Chairman Paul Volcker has proposed an increase in banks' required capital ratio to 9 percent from 6 percent of assets, and he indicated the Fed was ready to take a more active role in bank management by establishing guidelines for banks' dividend policies.\* At the early-October American Bankers Association convention, Chairman Volcker also revealed his support for basing capital requirements on the riskiness of a bank's assets. Necessarily this would substitute bureaucratic assessments of risks of various credits for market assessments, with all the associated potential for political abuse and for economic inefficiency.

At the level of multilateral agency intervention, it is plain that the IMF and World Bank will get

---

\* Hearing before the Senate Banking Committee, September 11, 1985.

more say in the domestic economic policies of countries that those institutions rescue with additional credits. The exercise of pervasive economic power by national, state, and local officials is highly dangerous in itself. No matter how appealing a specific program may be, far more dangerous is the granting of power to international-agency bureaucrats. They operate outside the direct reach of the American people, and under limited influence of the elected representatives of the American people. Beyond that, the more power central authorities get to direct financial flows, the less is available to individuals to exercise through the dispersed decision-making of the market process, the demonstrated more efficient way to organize economic activity.

Because credit — including credit instruments that are used as purchasing media — is an aspect of virtually all economic transactions as the financial counterpart to the exchange of real goods, the political control of credit greatly affects the real-goods sector. Since the turn of the decade there has been a reawakening in economic thought and policy to the importance of unfettered markets in fostering sustainably rapid real economic growth. This has been reflected in policies to constrain the growth of Government's spending (thus far unsuccessful); to reduce marginal tax rates; to reduce or eliminate many of the tax provisions (tax shelters) that distort the market allocation of capital; and to reduce regulatory control of the economy.

Deregulatory steps have included, pointedly, more competition in the financial-services market, including that for banking services. Among other things, this has included the phased elimination of interest-rate ceilings on various types of deposit accounts. Market participants in fact forced these deregulatory steps when depositors began to withdraw their funds from institutions and accounts whose maximum permissible rates were far below those available from other institutions and on other assets. But as the regulators have lost power over the money-credit mechanism via loss of control of competition in banking and interest-rate ceilings, they have been re-acquiring regulatory power via determination of higher capital-adequacy requirements and dictation of terms for bad-debts rescues, domestic and international. This spells much more trouble for the economy in the long run.

### THE FUNDAMENTALS OF UNSOUND CREDIT

The source of today's debt problem has been attributed by many analysts to the inflationary conditions of the 1970's. With reference to the Third World uncollectible debt, they reason that the multiple increases in oil prices during the 1970's

in large part were paid through inflationary increases in the money stock, which avoided the downward adjustments in the prices of most non-oil goods and provided huge petrodollar surpluses to OPEC countries that “had” to be recycled through the private international banks to Third World countries. With respect to the uncollectible farm debt, they argue that sharply rising prices of farm commodities and farmland during the 1970’s induced farmland buyers to borrow, and farm banks to lend, to the hilt on the expectation that prices would continue to rise and so provide the higher nominal-dollar revenues required to service the debt.

Such reasoning is not groundless. Inducements to excessive use of debt and to speculation on sharp price rises for particular assets are two of many reasons why inflating should not be intentionally undertaken to stimulate short-run economic growth. Yet, this situation does not justify the bailout of debtors who did not bother to learn the risks associated with investments that depend on inflationary conditions. Had their “investments” proven highly profitable, those individuals surely would not flood Washington with lobbyists and plans to share their gains with the American people.

There is an even more basic level at which the money-credit structure is flawed. Unless the system is reformed in these fundamental aspects, today’s pervasive debt problems are not likely to be significantly reduced. Palliatives of the type used in debt rescues to date probably will foster more similar troubles at more encompassing levels of financial and political consolidation.

Today’s debt crisis can be traced in part to the focus of economic thought and policy on aggregate *quantity* levels of activity to the virtual neglect of *quality* considerations. Keynesian thought focuses on total nominal demand, total output, the rate of total investment, the availability of total credit, the general level of interest rates, and other aggregate measures of economic activities. Except for the *distribution* of income, Keynesian thought gives scant attention to the extent of balance or imbalance among the individual units and components within the aggregates. Monetarist thought likewise rests on aggregates: the total quantity (supply) of “money” and control of its rate of growth through control of its reserve base. In monetarist thought, if the monetary base is appropriately controlled, market processes will operate to move the component parts toward equilibrium (sustainable) conditions. While changes in aggregate series are revealing and must be a part of useful descriptions of economic processes and relationships, they are not sufficient in themselves.

A total quantity of credit in and of itself does not reveal whether it is or is not a sustainable (equilibrium) amount. A sustainable credit structure is one in which every borrower is willing and able to pay in real value his debt as contracted at maturity. Banks as “borrowers” of depositors’ balances must pay their demand liabilities “on demand.” If debts between individuals, between banks, and between banking systems are continuously limited *in fact* to those which can be offset by monetary claims against other individuals, other banks, and other foreign institutions, *there is no limit to the volume of credit that can be sustained by a given asset-reserve base*. The corollary in the banking sphere is that a given ratio of bank asset-reserves to its liabilities does not determine if the amount of asset-reserves is or is not sufficient to support the liabilities.

### SOUND CREDIT RESTS ON THE EXCHANGEABILITY OF GOODS

A sound credit structure rests on the exchangeability of the specific goods debtors expect to sell to others in order to gain credits needed to offset their debts.\* This applies to banks (and their credit instruments used as “money”) as well as to nonbanks. For banks the exchangeability is one step removed; it is accomplished through the bank’s loan customers. An appropriate increase in total credit (and “money”), therefore, is determined by the increase in the volume, the exchange values (prices), or both of the explicit or implicit specific goods against which the credit is granted. If in every instance credit extension is limited to the in-fact-realizable real prices of the *goods debtors expect to exchange for credits* to clear their debts, both the distribution of credit and the total amount of credit will be sustainable.† Every individual debtor would have credits against other members of the community sufficient to cancel his debt; every bank would have credits against other banks sufficient to pay its depositors and to offset any debits with still other banks. The national banking system as a whole would have sufficient credits against foreign banking systems to offset debits with others. *All debts would be canceled by credits*. No transfer of reserve assets

\* “And services” is not added to “specific goods” because the provision of services ultimately is settled by the exchange of goods, although many exchanges of services for other services may occur before a good is taken in final exchange and consumed.

† The counterpart in the real sector of the economy would be continuously fulfilled expectations by producers and consumers – that is, general equilibrium in the goods sector. Jobs and incomes, therefore, would be maintained, which is the connection all debtors have to the exchangeability of goods as the source of credits to offset debts.

would be required by individuals, banks, or banking systems.

When, however, more credit is extended to individuals on the basis of the expected value of specific goods available for exchange than the debtor can exchange them for, the debtor does not gain sufficient credits from other members of the community to offset his debt. If the debtor has other assets he can exchange (sell) for credits sufficient in amount to offset his debt, the lender's (say, bank's) credits would remain sufficient to offset its debts.

But if the borrower does not transfer to his bank creditor sufficient credit to cover his debt, the bank would not have sufficient credits to offset its liabilities to depositors and/or its debts with other banks. It then might have to sell assets (constituting part of the bank's net worth, or capital) in order to gain enough credits to offset its debts with other banks.

Alternatively, the net debt position of the one bank (or many banks) might be maintained for a time. The banking system *as a whole* would continue to have a balance in debts and credit among the banks, inasmuch as the net debt position of some banks would be counterbalanced by the net credit position of others. No assets of the debtor banks would have to be sold. Therefore, if the debtor banks were many and if the book value of the assets held as net worth were far more than the banks could realize on a forced sale of them, the banking system as a whole could conceal the asset deficiencies, block appropriate adjustments in relative prices of assets, and prevent the contraction of total credit, including the "money" component.

A national banking system imaginably could maintain indefinitely a large imbalance in debts and assets among its separate component banks, and the separate banks in turn could do likewise for their individual debtors — were it not that there are international goods and credit flows. When credit is extended on a transaction involving a foreign entity, the potential arises for an imbalance between debts and credits among national banking systems. When those imbalances occur, the net-debtor system must transfer to the creditor system some internationally acceptable settlement asset to clear its debt. Or, alternatively, the creditor national systems might allow the debtor systems to remain indebted. As with the component-member banks of a national system, the credits and debits of the international banking system as a whole would remain in balance although some component national systems might be chronic net debtors. International adjustments in relative prices, wages, and flows of goods and

long-term investment funds thereby would be blocked.\*

These relationships are pertinent to the way today's debt crisis is being handled:

- The Federal Farm Credit System is created to direct more credit to agriculture than private market participants are willing to commit there. The credits turn out to be uncollectible, so it is proposed that the Farm Credit System be combined (indirectly) with the U.S. Treasury to cover the deficiency of its credits and of the market value of its capital-reserve assets.

- The FSLIC is formed to protect S&L depositors from unsound credits extended by individual S&Ls. But so many S&Ls have extended unsound credits that the FSLIC no longer can cover the deficiencies with its own credits and net-worth assets. A new organization is proposed in order to add some FHLBB credit power and asset reserves to the deficient ones of the FSLIC.

- Private banks in many countries made unsound loans to borrowers (private and public) in other foreign countries. The borrowers cannot earn enough credits to offset their debits with out-of-country lenders, and the debtor national banking systems do not have sufficient international settlement assets to transfer to the creditor systems to settle the deficiency. Creditor national systems transfer some of their international settlement assets and national credits to the IMF and World Bank and empower them to create or borrow more. This consolidates, in part, debtors and creditors among different national systems and thereby enables credits to be more nearly offset by debits. To the extent international settlement assets (reserves) are centralized in these institutions or are increased by them (the IMF's SDRs), these institutions can settle (pay) some of the remaining net deficiency of credits.

---

\* There is the possibility that such immediate adjustments should be "blocked," if nonpayment is attributable to a temporary condition, say, drought or cyclical recession. The difficulty is to differentiate at the moment between temporary and more lasting imbalances. Private creditors assessing the condition as temporary would be inclined to renegotiate the credits, albeit at perhaps penalty terms, in which event there would not be a reported imbalance. When governments act to offset private-sector imbalances and thereby block adjustment, the assessment of politicians as to the degree of permanence of the condition overrides that of market participants. There is no basis for expecting the politicians' decision to be more accurate. On the contrary, inasmuch as the time horizon of incumbent officials is the next election and inasmuch as they do not risk their own funds when they grant government credit, they are biased toward interpreting as temporary every imbalance that would require difficult domestic economic adjustment during their incumbency.

## SOUND MONEY AND COMMERCIAL LOANS

Today's massive debt problems thus are traceable to the extension of credit based on inaccurate estimates of realizable values from expected sales of goods. When a businessman extends credit to another businessman he receives the debtor's IOU. The creditor-businessman ordinarily does not use the debtor's IOU to make payments to other members of the community. If the IOU turns out to be uncollectible, the loss is absorbed by the creditor alone. (Although, if large enough, it could affect many employees, vendors and their employees.)

A bank's credit extension differs from that of a nonbank. When a bank extends new credit, it takes as an asset an IOU that does not circulate as purchasing media ("money") and extends its own IOU, a checkable deposit balance, that does serve as purchasing media. By substituting its own liabilities for those of individual nonbank debtors, a bank transforms specific debt into debt generally acceptable as a means of payment throughout the community. In doing so, a bank also has the potential for taking specific unsound, distortionary credits and generalizing them more widely in the community.

For all banks operating within a national banking system, the "community" is the national economy. Unsound specific credits of individual banks that are absorbed within a consolidated national banking system, therefore, have generalized distortionary effects throughout the national economy. And likewise for an international money-credit system and the international real-goods economy.

Since bank credit, especially that constituting "money," has a widespread effect on the community at large, it is of great importance to the fostering of a sustainable economic condition that banks accurately estimate the values in anticipation of sales of goods ultimately to be used to settle debts. In the words of one student of bank credit, "a banking system which extends credit only on goods which are in the process of marketing or as near final sale as possible, thus limiting the degree of anticipation, will not make as many errors in judgment as one which extends credit for the purpose of providing the capital equipment to be used in the production of other goods. Thus clearance will be improved and the necessity of resorting to reserves in order to pay for goods which have not been exchanged against other goods will be reduced. When a banking system ceases to base the medium of exchange on exchangeable goods and becomes more deeply involved in production, it is treading on dangerous ground. For by making the bonds of industry or loans on stocks the basis of its

deposits [Ed.—money creation], the bank incurs a larger measure of liability for the risks of industry. Even though its debtors fail to repay their loans, it must meet its obligations on demand. Therefore, not only will industrial mistakes affect the bank's net worth, but losses will have to be made up by payments out of its reserves."\*

The notion that banks should limit the creation of their monetary liabilities to the realizable exchange value (real prices) of newly produced goods being marketed is known as the "commercial loan theory" or "real-bills doctrine" of banking.† If purchasing media creation were so limited, the nominal supply of purchasing media would be continuously balanced by an equivalent real demand for it for effecting exchanges of goods. Chronic inflating would not occur. Early in this century monetary experts widely accepted the commercial-loan theory of banking, although it also had many critics. It had enough support that when the Federal Reserve Act was passed in 1913 the Act specified that member-bank borrowings from a Federal Reserve bank be backed by "eligible paper," specifically credit instruments evidencing such commercial loans. And Federal Reserve banks were required to back their "notes" outstanding, paper currency, by a combination of gold and commercial-loan credit instruments.

## FALLACIOUS FALLACIES

But over the years the commercial-loan principle of sound banking lost credibility among monetary "experts" and in monetary theory, as did gold. That these two formerly key aspects of sound money-credit arrangements fell into intellectual disrepute together is more than coincidental. The commercial-loan principle, or real-bills doctrine, of money and banking was said to be fatally flawed

\* William E. Dunkman, *Qualitative Credit Control*, Columbia University Press, New York, 1933, p.33.

† In a narrow sense a "real bill" is a specific type of credit instrument, being an order to pay (a "draft") a specified amount at a specified time (usually in 90 days or less), drawn by one business firm (or merchant) or another business firm (or merchant) to whom the first has shipped goods. (See *Instruments of the Money Market*, Federal Reserve Bank of Richmond, 1981, p. 114.) In a broader sense, a "real bill" is any type of credit instrument evidencing a short-term obligation arising in connection with goods being marketed. A broad-sense "real bill" involving a bank as creditor is a narrow-sense "commercial loan." The "real" modifier to "bill" is attributable to Adam Smith. He used it to differentiate bills of exchange that genuinely are "drawn by a real creditor upon a real debtor, and which as soon as it becomes due, is really paid by that debtor" from fictitious bills of exchange (Smith called them "circulating bills") that two or more traders conspire to draw and re-draw against each other when the earlier one becomes due, in effect never paying. (See *The Wealth of Nations*, Book II, Chapter II.)

by two fallacies.\* Lawrence H. White, in referring to Lloyd Mint's criticisms characterized them as the *nominalist* fallacy and the *inelastic-supply-of-bills* fallacy.†

The alleged nominalist fallacy is that the real-bills doctrine provides for the determination of one nominal quantity (the money supply) by another nominal quantity (the sum of the prices of the goods supporting the commercial bills of exchange) and, therefore, the doctrine will not prevent the creation of an excess nominal supply of purchasing media. According to the supporting reasoning, if goods prices rise for some nonmonetary reason (possibly because of some "shock" such as a poor harvest, an OPEC-like cartel, or war in another country), the initial price rises of those specific goods would warrant the creation of a larger nominal amount of commercial bills and this would induce an increase in the supply of purchasing media that would support the initial price increases and generalize the price rise throughout the economy. Accordingly, a vicious inflationary circle could arise, by which higher prices "justify" monetary expansion, which induces further price rises, and on and on. By this reasoning, the noninflationary nominal "money supply" would be an indeterminate quantity under the real-bills doctrine.

The nominalist fallacy now is widely admitted even by real-bills critics to apply only in a fiat-money regime. If the monetary unit is gold and all monetary liabilities are convertible into gold, "the domestic money stock is determined by the conjunction of the exogenously determined purchasing power of gold (world price level in terms of gold), the definition of the domestic monetary unit in terms of gold, and the desired real money balances of the domestic public."\*\*\* An essential aspect of the commercial-loan theory is that bankers accurately judge the realizable exchange value of the goods backing the short-term, self-liquidating loan. With gold as the monetary unit, bankers would have a standard against which exchange values (prices) of specific goods could be judged. If, nevertheless, a banking system as a whole created more convertible monetary liabilities than were justified by the gold-exchange value of goods mar-

\* See Lloyd Mint's *A History of Banking Theory*, University of Chicago Press, 1945, for a comprehensive (flawed) criticism of the real-bills doctrine and Thomas Humphrey, "The Real Bills Doctrine," *Essays on Inflation*, fourth edition, Federal Reserve Bank of Richmond, pp. 73-83, for a summary treatment of it.

† Lawrence H. White, *Free Banking in Britain*, Cambridge University Press, 1984, pp. 120-122.

\*\* White, p. 121. "Exogenously" refers to "external" conditions, specifically in this instance all the factors that determine the world exchange ratios between gold and other things.

keted, and if as a consequence the general price level began to rise, gold at banks would become a "bargain" in relation to newly produced gold and the people would present the bank liabilities for redemption in gold. This would leave the banks with smaller gold reserves and force them to cut back their liabilities in order to maintain a prudent gold-reserve ratio. The crucial aspect is that "the price level" would be determined by the exchange value of gold for all things in general, so an initial monetary excess could not feed back on itself indefinitely.

The alleged inelastic-supply-of-bills fallacy relates to the volume of bills offered to banks for discounting (that is, as collateral for bank loans) and thus used as the basis for increasing the nominal supply of purchasing media under the commercial-loan principle. Critics assert that, contrary to the doctrine's implicit assumption that the volume of real bills is determined by exogenous factors, the volume of bills offered to banks is determined by the rate of interest banks charge on their loans in relation to the rate of return borrowers can earn on the borrowed funds.†† Therefore, say the critics, banks can generate an increase in the volume of real bills presented to them for discounting by lowering their interest-rate charges and thereby "set in motion a process of cumulative expansion of bills, loans, money and prices."\*\*\*

White describes the fallacy as it applied to the Bank of England's operations even after gold convertibility was restored in 1821 (a period of repeated overexpansions and subsequent contractions of paper money and credit) in this way: "In theory, however, there was no obstacle to the bank's overissuing through aggressive discounting or open-market purchases of real bills. The qualification . . . that the bank should discount *at the market rate* was pointless, since the bank had the short-run power, by overissuing, to drive down the market."††† [Emphasis in original.]

Inasmuch as the Bank of England had been granted a monopoly of note issue in and around London and also was empowered to operate much as a central bank (its notes could be used as reserves by other banks), it could indeed adopt and pursue for some time a low-interest policy that would "set in motion a process of cumulative expansion of bills, loans, money and prices." Initial unsound credit extensions arising from the Bank's "aggressive discounting" would not generate re-

†† "Exogenous" in this context refers to conditions outside the banking system — specifically, all the factors that determine the volume of newly produced goods offered in the markets.

\*\*\* Humphrey, p. 80.

††† White, p. 122.

serve losses to other domestic banks (an internal gold drain) and force a change in policy because Bank of England liabilities (notes) served as reserves for other banks and those banks therefore had less reason to demand gold itself. Not until "easy credit" in England resulted in a gold drain out of the country (loss of reserves) was the Bank of England forced to contract domestic money and credit, with the consequences of higher domestic interest rates and economic recession. Even the Bank of England could "set" a below-market interest rate, an aggressive discount policy, only for a time.

A single bank operating in a competitive free-banking system is an interest-rate taker.\* *The* interest rate on *quality* real bills (those that actually, ex post, generate sufficient credits to clear the related debt) is a market-given figure. It would be determined by the time preferences of the people and the real rate of return on productive capital.† A single bank that would charge below-market rates would discover it would not earn an adequate return on its commercial loans, and one that charged a too-high rate would not attract borrowers.

For the competitive free-banking system as a whole (with no central bank), an "aggressive policy" to generate a higher total amount of bills would imply acceptance of lower-quality real bills. Lower quality in this context could imply only that virtually all bankers would nearly simultaneously overestimate the realizable exchange value of the goods supporting the loans, or intentionally disregard accurate estimates, with the consequence that more credit (including the money component) is granted than an accurate assessment would justify. Such lemming-like action by bankers could initiate a distortionary cumulative expansion process of more loans, more money, more spending, higher output and more bills to start the process again. But if any banker(s) were cautious, the aggressive bankers would lose reserves to the duly cautious one(s), and the aggressive ones would be forced to become more cautious themselves. Thus,

---

\* That the system might not be perfectly competitive does not imply that a single bank could operate largely as a price setter. On this point Ernst Baltensperger ("Alternative Approaches to the Theory of the Banking Firm," *Journal of Monetary Economics* 6, 1980, p. 18) commented, "... [T]he mere fact that these markets do not precisely satisfy all the requirements of a textbook perfect competition market model does not imply that the monopoly model is better than the competitive model. There are virtually no real world markets which precisely meet all the requirements of the former, either-both models are extremes, and the question is which one is the better approximation."

† Time preference refers to the decisions of income earners to spend and consume now or to save (and invest) and consume later.

only in the most improbable event that virtually all bankers simultaneously would become overoptimistic would the supply of real bills be overstimulated within a competitive, free-banking system operating on the commercial-loan principle. Under reasonable circumstances, the supply of real bills would indeed seem to be inelastic, contrary to the alleged inelastic-supply-of-bills fallacy.

## TWO POSSIBLE DIRECTIONS OF REFORM

The foregoing discussion of the overriding importance of limiting debts between individual borrowers, between banks, and between banking systems to those that in fact can be cleared against credits suggests the essential aspects of a sound money-credit structure: (1) gold as the monetary unit; (2) application of the commercial-loan principle of banking; (3) free banking (with no central bank) in order to subject individual banks and the entire banking structure to the continual test of reserve losses and continual discipline of market competition. During the past decade or so as monetary conditions domestically and internationally under fiat-money systems have been widely recognized as troublingly volatile, there has developed an increasing interest in and academic respect for a role for gold in a reformed monetary system. The possible roles mentioned cover a broad spectrum.

Not just any role for gold would be useful in restoring a sound system. As we have described, a monetary unit of gold is essential for establishing price-level determinancy; without such all prices and other monetary variables are totally relative.\*\* Gold as the monetary unit thus improves the accuracy of estimated values in anticipation of sales of goods expected to clear debts. For this standard-of-value function of gold to be effective, bank demand liabilities stated in the monetary unit must in fact be redeemable in gold at the option of the claim holder — that is, monetary claims must be fully convertible into gold.

Full convertibility is essential for two reasons. One is to provide the continuous market test and determination of exchange rates between things in general and gold, this is the process by which price level determinancy is made effective. If the general price level begins to rise and some money holders perceive the rise as an incipient chronic trend, those individuals should have a mechanism for directly affecting the levels of money and credit. Convertibility would provide it via money-holders'

---

\*\* We refer to gold as the monetary commodity rather than another commodity (or other commodities) because thousands of years of history indicate that, across national borders and generations, gold is the market's first choice as the monetary commodity.

withdrawal of gold and the related banks' loss of reserves.

Gold also is essential for use as the ultimate settlement (reserve) asset between banks (and between national banking systems). Inasmuch as gold is a monetary asset that is nobody's liability, its value in exchange and therefore its usefulness for settling debts does not depend on the saleability of other goods to provide an offsetting credit. Moreover, gold reserves cannot be created at the whim of bankers or monetary officials. Therefore, when credit advances lead to calls on bank reserves to settle unmatched debts such that the reserve base seems inadequate, nominal money and credit flows would change (and foster adjustment in prices and output) instead of fiat reserves being increased in order to make them sufficient for the settlement of greater unmatched debts. The repeated creation of additional fiat reserves by authorities in order to forestall incipient money and credit contractions (and related economic recessions or depressions) was the source of the modern inflationary era and of today's worldwide debt crisis. A gold-based monetary system outside the control of authorities would induce earlier correction of (1) unsound money and credit creation and (2) the related real-sector maladjustments.

The commercial-loan principle of banking, we submit, would re-evolve voluntarily in a free-banking, gold-based monetary regime for the reasons described above — in short, because it best assures the settlement of bank liabilities by offsetting credits rather than by the depletion of bank reserves. This principle of sound banking need not, and should not, be established by regulation or law, because

banking practices should be determined by market forces and not imposed "by authority." However, as mentioned above, experience with sound commercial banking during the 19th century was favorable enough that it was incorporated in the original Federal Reserve Act. Admittedly, its application leaves room for error and abuse, which impose a subsequent real-sector adjustment cost. But so does the market process for other goods and services.

As with those other goods and services, the alternatives to market-determined money seem much more costly in terms of both economic efficiency and freedom. The slow dismantling of external constraints on reserve and money creation and of ever-broader cover-ups of unsound credit and unmatched debts has left a world debt mess that has yet to be solved. The full price for fiat monetary abuses is far from having been paid in terms of real-sector adjustment. At the same time, as mentioned above, control of credit flows is being increasingly concentrated in the political arena, even in the international bureaucracy. With it goes control over real economic output and consumption.

A critical juncture in money-credit thought and policy is approaching. For those who think experience has amply demonstrated that economic freedom is a *sine qua non* of economic advancement and political freedom, present money-credit trends must be deeply disconcerting. The trend toward greater political manipulation of money and credit must be reversed to enhance the prospect of sustained economic progress. A competitive, free-banking, gold-based monetary regime operating on the commercial-loan principle would be the sound solution to today's financial and monetary mess.

**LIMITED SUPPLY OF 3-RING BINDERS AVAILABLE**

**ORDER NOW FOR 1986**

*AIER still has some 3-ring binders for **Research Reports** and the **Investment Guide**. These attractive, high-quality binders have a dark blue vinyl cover, with "Research Reports/Investment Guide" printed in gold lettering on the front and "American Institute for Economic Research/American Investment Services, Inc." on the spine. Each binder will hold a full year of both **Research Reports** and **Investment Guide**.*

*The binders are available for \$5 each, including postage and handling, which approximately covers our cost.*

*Please allow a few weeks for delivery.*

**BOOKLETS OF AMERICAN INSTITUTE FOR ECONOMIC RESEARCH**

*Abbreviations*

AMERICA'S UNKNOWN ENEMY: BEYOND CONSPIRACY by Robert A. Gilmour (36 p., 1984)	UN
ANNUITIES FROM THE BUYER'S POINT OF VIEW by Ernest P. Welker (33 p., 1985)	AN
CAN OUR REPUBLIC SURVIVE? Twentieth Century Common Sense and the American Crisis by the Editorial Staff (55 p., 1969)	TC
CAUSE AND CONTROL OF THE BUSINESS CYCLE by E. C. Harwood (82 p., 1974)	CC
ECONOMICS IN YOUR INTEREST by Bartley J. Madden (34 p., 1984)	EI
FORECASTING BUSINESS TRENDS by Thomas F. Davis (32 p., 1983)	BT
HOMEOWNER OR TENANT? How To Make A Wise Choice by Lawrence S. Pratt (32 p., 1982) [1985*]	HT
<b>HOW TO AVOID FINANCIAL TANGLES</b>	
Section A: Elementary Property Problems and Important Financial Relationships (Including Wills, Trusts, and Insurance) by Bruce H. French (44 p., 1984)	HF-A
Section B: Taxes, Gifts, and Help for the Widow by Bruce H. French (26 p., 1981) [1984*]	HF-B
Section C: Trusts May Be More Useful Than Many Realize by Ernest P. Welker (36 p., 1984) [1985*]	HF-C
<b>HOW TO COVER THE GAPS IN MEDICARE</b>	
Health Insurance Options for the Retired by Robert A. Gilmour (32 p., 1985)	CM
† INVESTMENT COMPANIES AND FUNDS: A Mutual Fund Primer for Investors by Bruno M. Larsen (55 p., 1985)	IF
IS DEFLATION COMING? edited by Lawrence S. Pratt (36 p., 1985)	DC
KEYNES vs. HARWOOD – A CONTRIBUTION TO CURRENT DEBATE by Jagdish Mehra (24 p., 1985)	KH
LIFE INSURANCE FROM THE BUYER'S POINT OF VIEW by Ernest P. Welker (48 p., 1985)	IB
MONEY, BANKING AND INFLATING A Useful Description by Lawrence S. Pratt (24 p., 1981)	MB
RECONSTRUCTION OF ECONOMICS by E. C. Harwood (46 p., 1970)	RE
SENSIBLE BUDGETING WITH THE RUBBER BUDGET ACCOUNT BOOK (38 p., 1984)	AC
SOUTH AFRICA IN CONTEXT by Ernest P. Welker (19 p., 1985)	AF
SURRENDERING AMERICA: A Decade of Unilateral Disarmament by James Finnerty (36 p., 1980)	SA
UNDERSTANDING THE MONEY MUDDLE And How It Affects You edited by Ernest P. Welker (20 p., 1980)	MM
USEFUL ECONOMICS by E. C. Harwood (53 p., 1970)	UE
WHAT WOULD MORE INFLATING MEAN TO YOU? edited by Lawrence S. Pratt (32 p., 1981)	MI
WHAT YOUR CAR REALLY COSTS: How to Keep a Financially Safe Driving Record (41 p., 1985)	DR
WHY GOLD? edited by Ernest P. Welker (37 p., 1981)	WG

\* Revised. Prices: \$3 each – any 2 for \$5, 3 for \$7, 4 for \$9, 5 or more \$2 each.  
 † \$8 each, no quantity discount.

You can order booklets from the above list by writing the listed abbreviation(s) in the space provided on the order form and sending it to us with your check for the appropriate amount. Furthermore, you can receive our twice monthly 4-page *Research Reports* and our monthly *Economic Education Bulletin* booklets by selecting an **Annual Sustaining Membership**. In our twice monthly *Research Reports* we analyze economic developments and in our *Economic Education Bulletin* we describe basic economic relationships and events. Or you can receive only the *Economic Education Bulletin* by selecting our **Education Membership**. Please use the order blank below.

**INVESTMENT GUIDE**

At your request, AIER will forward to American Investment Services, Inc. (AIS) your payment for a subscription to their *Investment Guide*. The *Guide* is issued once a month at a price of \$32 per year (add \$8 for foreign airmail), or \$10 per quarter (add \$2 for foreign airmail). It provides guidance to investors, both working and retired, of modest and large means, to help them preserve the real value of their wealth during these difficult financial times. AIS is wholly owned by AIER and is the only investment advisory endorsed by AIER. (The \$32 paid for the *Guide* is deductible from income as an investment expense.)

AMERICAN INSTITUTE FOR ECONOMIC RESEARCH  
 Great Barrington, Massachusetts 01230

Enclosed is \$ \_\_\_\_\_ for:

- [ ] \$41 for **Annual Sustaining Membership** . . . . . or [ ] \$73 with *Investment Guide* for year.
- [ ] \$12 for **Sustaining Membership**, quarterly rate, . . . . . or [ ] \$22 with *Investment Guide* for quarter year.
- [ ] \$17 for **Education Membership**, annual rate, . . . . . or [ ] \$49 with *Investment Guide* for year.
- [ ] Booklet(s) by abbreviation(s): \_\_\_\_\_ Total for books \$ \_\_\_\_\_

Name \_\_\_\_\_ Address \_\_\_\_\_  
 City \_\_\_\_\_ State \_\_\_\_\_ Zip \_\_\_\_\_

---

**ECONOMIC EDUCATION BULLETIN**

**AMERICAN INSTITUTE FOR ECONOMIC RESEARCH**  
Great Barrington, Massachusetts 01230

Second class postage paid at  
Great Barrington, Massachusetts