Money Supply and Short-Term Assets

by BENT JENSEN

IN his interesting article, "The Monetary Spigot—On or Off" (Mar. 1970), Oscar B. Johannsen refers to the American economist Milton Friedman and says that bank notes and demand deposits should be created only in response to short-term assets such as goods enroute to market, and not in response to long-term assets, like buildings, factories and real estate.

It seems that Mr. Johannsen's viewpoint is in agreement with ideas advanced by prominent economists, virtually since the early 19th century.

According to the statutes of Banque de France, founded in 1800, the duties of the bank should mainly consist in "discounting of bills and other 'or order' claims falling due in less than three months and bearing the signatures of business men and other persons considered to be solvent."

In 1810 the Emperor Napoleon's Minister of Finance, Mollien, in a letter to Banque de France, stated:

"The purpose of placing a stock of gold at the disposal of Banque de France is not to provide the bank with the requisite means to make use of its right of note issue; the gold stock is not intended for bill-discounting, since the bank is not supposed to discount by means of its gold holding. Its right of note issue consists in procuring, in fact in creating, a special kind of money for bill-discounting. By note issue the bank should—independent of its gold—create its real and only means of discounting."

The views maintained by Mollien were also voiced in other countries, especially in England, where, from time to time, banking experts tried to convince the government that the note issue should not be determined by the quantity of gold deposited in Bank of England, but by the quantity of commodities put on the market. Time and again the experts claimed that if the bills discounted were of indisputable value the bank notes issued to implement the discounting had all the backing necessary for the purpose and consequently the note issue could not be excessive.

The renowned Swedish economist Professor Gustav Cassel, who lectured at American universities on monetary problems in 1928 maintained, in his book *Penningväsendets Utveckling,* that trade bills form a more suitable backing for note-issue than anything else, since the bills represent a supply of goods in preparation for or enroute to the market. He continues:

"When the note-issuing bank discounts such bills, the continuous flow of goods constitutes the backing for the bank notes paid the clients, and since the notes, when spent on the commodities in question, enable the ultimate debtors to honor their bills, a backing like that must be considered natural and sound."

Unfortunately, the monetary ideas advocated by Gustav Cassel and some other economists at that time were disregarded in most countries, and despite inflationary difficulties all over the world, the majority of note-issuing banks still persist in purchasing long-term securities and granting loans on them, this policy is characterized by an obvious absence of any connection with the supply of goods on which the money will be spent.

To all appearances, bank notes and demand deposits on long-term assets lack the built-in mechanism that makes short-term money return to the bank at the same time that the commodities, which form the backing, reach their ultimate destination.