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Monetary Stimulus

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*"How did you go bankrupt?" Bill asked. "Two ways," Mike said. "Gradually and then suddenly."
— Ernest Hemingway, The Sun Also Rises, 1926.*

An Economic Fable.

A few days ago a friend forwarded me an email containing this little economic fable:

It is a slow day in the small rural town, and the streets are deserted.

Times are tough, everybody is in debt, and everybody is living on credit.

A tourist visiting the area drives through town, stops at the motel and lays a \$100 bill on the desk, saying he wants to inspect the rooms upstairs to pick one for the night.

As soon as he walks upstairs, the motel owner grabs the bill and runs next door to pay his debt to the butcher.

The butcher takes the \$100 and runs down the street to retire his debt to the pig farmer.

The pig farmer takes the \$100 and heads off to pay his bill to his supplier, the Co-op.

The guy at the Co-op takes the \$100 and runs to pay his tab at the saloon.

The saloon keeper, who lives a few miles from town and occasionally stays at the motel instead of driving home after closing up, rushes to the motel and pays off his room bill.

The motel proprietor then places the \$100 back on the counter so the traveler will not suspect anything. At that moment the traveler comes down the stairs, states that the rooms are not satisfactory, picks up the \$100 bill and leaves.

No one produced anything. No one earned anything. However, the whole town is now out of debt and now looks to the future with a lot more optimism.

And that, it appears, is how a "Stimulus Package" works.

The fable is timely because the sudden shutdown of much of the economy resulting from stay-at-home orders in this epidemic season has caused a variety of market dislocations, including dangerous wobbles in the operation of credit markets. The Federal Reserve has responded with truly massive monetary responses, providing a variety of supports for the liquidity of those markets. From the fable's postscript about a "Stimulus Package," it appears that the point of the story is to suggest, in what is doubtless meant to be a humorous way, that beyond rather dubious psychological benefits, monetary policy responses to economic downturns are vacuous. But on a closer examination, the fable points to quite the opposite conclusion. An injection of liquidity — even a temporary one — into an economy where money is tight can in fact produce a meaningful improvement in economic conditions.

Let's start with the statement, "No one produced anything. No one earned anything." It's simply wrong. The traveler's \$100 traces a circle of obligations that came about precisely because each character in our little drama did produce or provide something of value. They each had earned their \$100, but because the town's local economy lacked liquidity, they all did business on account, extending credit and receiving it in return. That credit rested on each party's ability to continue to produce something, to earn something.

History shows that communities ranging from small places with strong personal ties to large ones with strong institutions can operate stably on credit for long periods of time. When cash is scarce, merchants and others can and do conduct business on account, settling up when their accounts drift too far out of balance, or when an unusual opportunity to pay up presents itself. This mode of doing business has practical bounds. Parties extending credit bear the risk of default, so they set limits, either explicitly or informally, to the balances they carry. When customers' balances approach their credit limits, they have to reduce their balances by providing something of value in exchange, either in payment or in kind. If they can't, then they will no longer be able to obtain goods or services from that creditor. If their situation is bad enough, they may also suffer so much reputational damage that they can't buy from anyone else either. They may go bankrupt suddenly.



A credit-based economy also has systemic risks. Defaults by tenants, for example, may cause their landlords to default on their obligations, potentially cascading through the system. Imagine the town in our fable if the motel owner became reluctant to allow the saloon keeper to stay in the motel on credit and the saloon keeper no longer allowed the Co-op guy to run a tab. Activity could stop altogether. After that, no one would produce anything; no one would earn anything.

In the fable the traveler's \$100 bill allowed the business people in the town to make a partial settlement of their accounts, potentially relieving pressure on their ability and willingness to extend credit to each other and restoring some of the credit capacity of the town's economy. This easing of credit could then facilitate future Production and Earnings. When the Federal Reserve supports the liquidity of the credit markets, it is doing much the same thing. So long as the productive capacity of the economy remains intact, a temporary injection of liquidity can ease credit, allowing economic activity to continue.

An Historical Example.

Economies that run on credit, rather than cash, have been common throughout history. I have been conducting extensive historical research into banking and finance in Gold Rush California, and that research has brought to light, or at least to my attention, a good example of a credit-based economy. We like to think of Gold Rush California as operating on a hard-money basis, and in fact during the early 1850s physical gold did intermediate a good deal of everyday commerce in California. But the decades just prior to the Gold Rush, particularly the 1830s and most of the 1840s, were quite different. Fortunately, we have extant good primary source material that illuminates how merchants in San Francisco, or Yerba Buena as it was called prior to 1847, did business in that period.

William A. Leidesdorff was one of the leading merchants in Yerba Buena in the 1840s, and just prior to his untimely death in 1848 he may have been the wealthiest person in the town, and possibly in California. I have written more extensively about Leidesdorff elsewhere.

The California Historical Society's North Baker Library holds a rich archive of Leidesdorff's business records in its manuscript collection. For our purpose here, the most interesting item in the collection is an 1846 ledger representing an account Leidesdorff had with Henry Mellus, another important merchant in Yerba Buena.¹ This ledger begins on April 26, 1846 with a balance forward showing Leidesdorff owing Mellus \$1344.71½, to which he added



Captain William A. Leidesdorff was believed to be born in St. Croix, Danish West Indies in 1810 to a Jewish Danish sugar planter and a black plantation worker. He is considered by some to be California's first Black millionaire. Gold was also found on his property shortly before he died in 1848.

small amounts in July and August. During the period of the account Leidesdorff made ongoing payments to Mellus, sometimes in other commodities, but most often in cattle hides (often used as ersatz currency in pre-Gold Rush California), credited at \$2 each.

The key transactions in the Mellus ledger occurred in late October 1846. Leidesdorff had evidently received in payment on other business two Russian bills of exchange, basically money orders, one for \$2000 and one for \$1000. The most likely source of these bills was the Russian brig *Baykal*, under the command of a Lieutenant Rudierkoff. That brig, according to the Californian newspaper of September 12, 1846, arrived from Sitka, in Russian America, on September 10, having "Come for a cargo of wheat."² Sitka, a port on the archipelago that now makes up the southeastern part of Alaska, was a Russian fur trapping and trading post. It depended on trade for basic provisions. California newspapers in 1846 and 1847 made regular mention of arrivals from Sitka, but these ships do not seem to have brought furs, which would not have been much in demand in California. The California *Star*, reporting on a later arrival from Sitka, the brig *Constantine*, noted, "She brought nothing but stone as ballast."³ Most likely *Baykal* arrived in a similar condition, carrying no valuable cargo, but bringing bills of exchange to purchase a cargo of wheat and other provisions. The bills were in round numbers of \$1000 and \$2000, rather than in precise sums to meet an invoice, suggesting that the Russian purchasers had obtained them ahead of time.



Northern Sea Otter - source of furs for the Sitka trade. This is a sub-species distinct from the California Sea Otter characteristic of Monterey Bay. US Marine Mammal Commission.

We have no details of the Russian bills of exchange aside from their denominations, but Leidesdorff and Mellus must both have judged that they represented realizable value, ultimately deriving from the Russian fur trade. So Leidesdorff accepted them in payment — presumably for the wheat Lieutenant Rudierkoff had come south to buy. (Leidesdorff's account with Na-

¹ "William A Leidesdorff in Acct Current with Henry Mellus," October 30, 1846, William A. Leidesdorff Collection, 1834-1857, 1928, MS1277, California Historical Society, Manuscript Collection, San Francisco.

² "MARINE INTELLIGENCE," *Californian*, September 12, 1846.

³ "The Weather," *California Star*, January 23, 1847.



than Spear reflects a purchase of 203 fanegas of wheat on October 2, which may well have been part of this transaction.) Since Rudierkoff was a naval officer, the bills may have borne some Imperial imprimatur. Rudierkoff was a regular visitor to Yerba Buena, so Leidesdorff and Mellus were personally acquainted with him.



Sitka (Novo-Arkhangelsk), Russian America, in 1844. Wikimedia Commons.

It seems extraordinary that a merchant in San Francisco would have accepted a paper instrument from a Russian sea captain in payment for a valuable cargo, but the use of such instruments in international trade was a well-established practice, even on the remote Pacific coast of North America. Reputation was still important, of course — Leidesdorff and Mellus both knew Rudierkoff personally, and the bills of exchange themselves must have borne some credible evidence of sound backing, either commercial or Imperial.

In any case, the arrival of Rudierkoff and his bills of exchange enabled a flurry of settling-up transactions, which must have improved credit conditions in San Francisco. Mellus allowed Leidesdorff to give him the Russian bills to pay off his debt, and returned cash for the excess — after applying a discount of 12-1/2%. Leidesdorff's account shows that, on the strength of the Russian bills, Mellus also made payments of over \$840 (after applying the same 12-1/2% discount) on Leidesdorff's behalf to another merchant, John (or Juan) Paty. Paty was master of the barque *Don Quixote*, which traded primarily between Honolulu and Monterey, and partner in the merchant house of Paty & Co. (Trade with both Alaska and Hawaii was a feature of economic life in San Francisco even when San Francisco was part of Mexico, Alaska was part of Russia, and Hawaii was an independent Kingdom.)

Mellus and his partner, William Howard, were active in shipping cattle hides from California to New England. He most likely realized the value of the Russian bills by forwarding them on to his bankers in Boston.

The arrival of the Russian trader with his bills of exchange proved to be an injection of liquidity into the economy of Yerba Buena, even though the bills themselves were not money, but credit instruments. They allowed Leidesdorff to settle his account with Mellus, either settle with Paty or lend him cash, and retain cash on hand for other business. Like the traveler's \$100 bill in the fable, it was a single monetary flow that permitted the adjustment of multiple credit arrangements within the local economy.

Credit in Our Economy.

If you listen carefully to senior economic policymakers when they talk about monetary stimulus, you'll hear that they often speak of injecting "credit" into the economy. They use this language for good reason. Our modern system of money and banking rests entirely on credit. In a way, we have reverted to the type of system Leidesdorff and Mellus knew, one in which we mediate commerce not with physical money, but with credit. Even routine retail purchases work that way. When you insert your credit or debit card into a card reader, or tap your phone on an electronic payments device, the transaction you initiate consists entirely of adjusting debit and credit balances on various parties' balance sheets, including your own. Payments by check do the same — they just take longer to clear. Even if you hand over physical currency, what you are tendering are tokens representing claims against the Federal Reserve, which function as money by convention, and because they enjoy protected status as legal tender.

Most of the time, private transactions in the credit markets keep them functioning smoothly, providing access to the capital and liquidity the economy needs to operate. When those markets sputter as they have recently, they imperil the economy's circulatory system, threatening economic activity in general. At that point the Federal Reserve may step in by injecting credit into the markets, giving them the breathing space necessary to recover.



19th Century sailing ship, such as used in overseas trade. Chicago Museum of Science and Industry.

As the Leidesdorff material illustrates, the distinction between money and credit has long been murky. In our modern economy, credit and money have merged almost entirely. Every financial asset you own — the stocks and bonds in your portfolio, your bank account, even the currency in your pocket — is someone else's liability. The balance sheet, whether formally drawn up or merely conceptual, has become both store of value and medium of exchange. A dollar is merely a unit of account. If the Federal Reserve steps in to provide facilities helping wobbly credit markets recover their normal functions, yes, that is a lot like the traveler and his \$100 bill. But it is not a vacuous exercise. Instead, it can prove to be essential to the continued function of not just the financial system, but the real economy as well.

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