Master Thesis

# The Role of Credibility in the Transition from Bills of Exchange to Fiat Money

Handed in to

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# Executive Summary

This master thesis will address the role credibility played in the transition from commodity money to today's ubiquitous fiat money, especially by investigating how credibility helped the bill of exchange to function as a bridge between the two concepts. It will start by addressing the structural forces of the medieval economy, will highlight the role of the merchant bank in the early credit creation process, will analyse how endorsement and the joint-liability rule helped overcome information asymmetries like moral hazard or adverse selection and how the bill of exchange entered into the real bills doctrine, and eventually functioned as a facilitator for fiat money.

The medieval economy relied solely on commodity money, i.e. money that derived its value from the precious material from which it was made. It was constantly in short supply, and agents of the medieval economy – mainly farmers, craftsmen, merchants, gentry and church – were constantly short on cash. Sales credit was therefore commonplace, even though the ban on usury meant taking interest took place at risk.

It will be shown that ban on usury slowed financial innovation down, but merchants adopted a financial instrument that become known as the bill of exchange, a paper that involved a payment obligation from one merchant to another, to be mostly paid by a third party. One reason was sheer necessity for a financial instrument: constant liquidity shortage, difficulties to transport barter money and the internationality of trade all meant that cash was no option.

This paper demonstrates that the bill of exchange was the instrument of choice because it displayed characteristics other financial tenders did not: it was endorseable, meaning transferrable by accepting the payment obligation by signing on the bill's back, thereby using it for one's one purposes – a direct result from trade fair giros – ; and it was jointly liable, helping to enforce international contracts because every party using a bill of exchange for settlement were liable for full payment of face value.

It will be shown that these characteristics also helped market participants to overcome information asymmetries like moral hazard or adverse selection, and hence made the bill of exchange the superior choice for tradesmen of the early modern period. Also, a large and

growing network of merchants having turned into merchant banks helped with cross-border clearing and facilitating the widespread acceptance of the bill of exchange.

Medieval sales credit led to full scale credit creation in the 18th and 19th century, and since it is argued in this thesis that bills of exchange had warmed agents to the notion of value representation by means of tokens, what by the mid-18th century had already become a reality was soon picked up by commercial banks in a broader context of money creation, coined the real bills doctrine. This meant that money in the form of sight deposits or tokens thereof – the first form of paper money – was created in line with the expansion of credit, granted to businesses upon the discount of good real bills, i.e. bills of exchange representing future profits and further collateral.

The practice of creating credit and money only upon the discount of bills invited critics to call for money to be backed by some tangible asset like gold or land, fearing that otherwise, credit creation would lead to inflationary cycles and all credibility in the system would be lost. Bullionists – supporters of the real bills doctrine – claimed, on the other hand, that the system is sufficient in containing inflation and in sustaining credibility. Both sides have had valid arguments, but it is a misconception to believe that the real bills doctrine is immune to gold backing.

It was found that here representative money closes another gap between the bill of exchange and modern fiat money. The notion of token of value meant that the first banknotes ever printed – first by merchant banks, and later, in the forming of nation states, by central banks – were nothing but vouchers for gold (coins), redeemable at the central bank's cashier. These early bank notes, however, fulfilled nearly all requirements of modern fiat money: they were intrinsically valueless and they were declared legal tender. And they bore a striking resemblance to the bill of exchange, namely: the face value represented real economic value.

Indirect gold convertibility was finally and lastingly dropped when the Bretton-Woody system collapsed in the 1970s. Since then, all major currencies are fiat money and created not because a precious metal is an underlying, but some other notion of value (today, it is usually a government bond).

This paper suggests that fiat money is still the most credible – i.e. believed in and convincing – form of money there is. The way fiat money is created may require revision, but even though – at the time of writing – currency devaluation, negative interest and inflation rates have become a regular occurrence – all present evidence suggests that fiat money has lost little of its appeal. It is true that prices of tangible assets such as gold and real-estate have risen – and they are fiat money's logical counterpart – but it is not to gold that Greek citizens flock in fear of reverting to the drachma, but it is to the Euro, a true fiat currency.

Also, to put paper money creation in a broader context, medieval Chinese developments are briefly eluded in order to show similarities and differences. It can be shown that credibility played a nearly equally important role in China than it did in Europe.

This paper showed that it is the bill of exchange's doing that fiat money is as widely accepted and believed in, i.e. credible, as it is today and will likely be in the future. The shortcomings of commodity money and the medieval needs of trade were the initial factors for a process of change, but credibility played the most important part in that transition from commodity to fiat money, and the bill of exchange was the logical bridge between the two concepts.