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THE SEVENTH PILLAR OF SOUND MONEY AND CREDIT

THE PRINCIPLE OF LIQUIDITY

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A Venetian Tale

Once upon a time, a wealthy merchant died in Venice. He was survived by his widow and three sons. His will listed a fortune consisting of 1000 gold ducats: and a wheat farm, a flour mill (both in Lombardy), and a bakery in Venice, each worth 1000 ducats. The old man's will ordered his whole fortune, worth 4000 ducats, to be divided equally among the four survivors. Another clause required that, in case of any disagreement between the survivors, the farm, the mill, and the bakery should be sold and the proceeds divided equally.

The eldest son wanted the farm, the middle son the mill, the youngest son the bakery while the widow was satisfied to have the gold.

The trouble was that no one knew where to find the gold mentioned in the will. Venice was full of the news that a spectacular lawsuit was in the offing, each survivor suing every other for embezzlement.

The Doge was a wise old man, who did not want to hear the survivors accuse each other. So when they appeared before him and sued for justice, he asked the eldest son what kind of crop he expected to bring in. "At least 2000 bushels," was the answer. The Doge

turned to the middle son and asked how much flour would 2000 bushels of wheat grind into. "At least 80,000 pounds," answered the middle son. Then the Doge asked the youngest son how much bread he can sell out of 80,000 pounds of flour. "At least 1000 ducats' worth," the youngest son answered.

At this point the Doge turned to the widow and said to her: "There is your 1000 gold ducats. You just have to help each other until the wheat matures into flour, the flour matures into bread, and the bread matures into gold."

As the Doge dismissed them, he said to the three sons: "According to the proverb, not all that glitters is gold. Your late father has now shared with you the last measure of his wisdom, which is this: A lot of things don't glitter at all, yet they may be well on their way to ripening into gold in your busy hands."

Self-liquidating paper

Just as wheat ripens into gold by the time the flour is baked into bread, so does every other merchandise, at the time it is offered for sale to the ultimate, cash-paying customer. We may express this ripening process by saying that, as the semi-finished goods become finished goods, they also become 'liquid.'

When a commercial bank makes a loan to a producer or distributor, the commercial paper that arises becomes the bank's asset. Commercial paper is considered liquid, if the underlying merchandise is liquid. Such paper is also called 'self-liquidating', because at the time the merchandise ripens into gold, the gold coin of the consumer will liquidate the loan.

By contrast, a loan to finance the construction of a building is not liquid, let alone self-liquidating, because it may take decades before the brick and mortar sunk into the building can amortize the construction costs. Further by contrast, a loan for carrying a speculative storage of goods is not liquid, because the goods are not moving, and they won't be sold before the bank loan matures. The financing of such slowly maturing projects should not be in the purview of the commercial banks; they should be left to the investment bank which uses actual savings for the purpose, as we shall see in the Eighth Pillar.

Propensity to consume

Commercial banks do not depend on saved funds for their operation, as do investment banks. They finance trade by relying on the liquidity of maturing merchandise. Commercial paper can and does circulate in the sense that a second bank will always be glad to acquire it as an earning asset if the first bank needs cash in a hurry.

Commercial paper is an earning asset because it is bought and sold at a discount below face value, the amount of discount being proportional with the number of days to maturity. The discount rate is inversely related to the "propensity to consume": the

greater this propensity the lower is the discount rate, and vice versa. The commercial bank derives its profits from the fact that, while it has earning assets, it usually pays no return to its creditors on the corresponding liabilities (called bank deposits).

To summarize, whereas investment banking relies on the propensity of the people to save, commercial banking relies for its operation on the propensity of the people to consume. It is the propensity to consume that puts consumer goods on the move and makes commercial paper representing them liquid.

The highest quality commercial paper matures in 91 days or less. That time is just the length of the seasons, and consumer demand and consumption patterns do change with the seasons. If a certain type of merchandise cannot be sold in less than 91 days, then it cannot be sold for another 365 days, before the same season of the year comes around once again.

The Principle of Liquidity asserts that the earning assets of the commercial banks must consist of self-liquidating paper drawn on consumer goods moving from the producers to the market, which will be sold to the ultimate cash-paying consumer in 91 days' time or sooner. Commercial banks must keep away from finance paper, or commercial paper drawn on slowly moving merchandise, mortgages, stocks, bonds. etc. None of these has the liquidity to be eligible as an asset in the portfolio of commercial banks.

The Real Bills Doctrine

As long as the commercial banks respect the Principle of Liquidity, they can't get into trouble, nor can the banking system as a whole. Should an individual bank experience unusually heavy cash withdrawals, it would find a ready market for its earning assets because other banks with excess cash would be happy to buy liquid assets. If the banking system as a whole experiences unusually heavy cash withdrawals, this can also be met without difficulty as the assets of the banking system get more liquid with the passing of every day and at least one-ninetieth of those assets mature into gold on each and every business day. The only scenario which would embarrass the commercial banks is the one in which the people stopped consuming altogether - but this is too far-fetched for serious consideration. Trouble only comes if banks yield to temptation, and get involved with slow paper.

We owe the Principle of Liquidity to the great 18th century Scottish thinker, the father of classical economics, Adam Smith. He was the first who expounded the "real bills doctrine," as this principle is also known, in his book, *The Wealth of Nations.* He noticed that before the Bank of England opened a branch office in Manchester, commercial paper drawn on the rapidly moving merchandise in Lancashire circulated very much as banknotes would, under their own steam and on their own wings. They did circulate, because their liquidity was the highest, second only to that of the gold coin.

There is no way to make stocks, bonds, and mortgages to circulate on the pattern of the circulation of commercial paper, for lack of sufficient liquidity.

The banking system in the United States is not just illiquid, but is in an advanced state of petrification. Only a small part of bank assets could be liquidated on short notice without great losses. The commercial banks rely on the Federal Reserve to replenish their reserves daily, rain or shine. The assets of the Federal Reserve banks are not much better: they consist of government securities. In case of a run, the Federal Reserve would be in no position to meet the demand for cash through honest asset-liquidation, because it would break the bond market. The Fed would have to monetize the bad assets of the commercial banks, which would make its own position even less liquid. Therein lies a great danger.

We may have to pay a high price for our contemptuous disregard for the Principle of Liquidity.