Resumen Liquidity

In *Liquidity,* Palyi exposes the inherent fallacy of the **quantity theory of money**: that velocity of circulation is an independent variable not subject to control by monetary policy. He points out that velocity can be controlled only by a banking policy that respects liquidity. Velocity cannot run away if all bank loans are strictly short term.

According to the theory, as developed by H. Thornton (1802) and J. Fullarton (1844), banks do not necessarily add to the volume of circulating media, but only "monetize" such credit instruments as have existed before into a more readily circulating form.

Bajo esta teoría:

- The banking mechanism is such as to adapt the credit volume to the flow of goods in an "elastic" fashion.
- the rules for liquidity of bank loans do not always, or at least not fully, apply to banks' (secondary) reserves, for which marketable securities, especially Treasury bills, may offer a more readily liquidated form of investment.
- German banks combined commercial banking with investment banking, and financed industrial development on a rather nominally short-term basis.

H. G. Moulton

His point was that very few commercial loans could be relied upon for liquidation; and in time of crisis no liquidation is possible at all. (Loans son líquidos sólo para ellos).
The loans are based much more on a permanent "alliance" of the banks with other business units than on the financing of specific completed transactions, and are less "liquid" than marketable securities. Liquidity, indeed, in the sense of liquidation, has meaning only for the individual firm.

SHIFTABILITY: an approach to keep banks liquid by supporting the shifting of assets. When a bank is short of ready money, it is able to sell or repo its assets to a more liquid bank (traditional theory) The banking system as a whole, Moulton thought, does not know any liquidation other than the shifting of assets from one bank to another.
Shiftability takes the place of liquidity

If credit lacks "quality" except for some artificial and readily creatable type, then, of course, the purely quantitative manipulation of the credit volume is the "real thing."

on the other hand, most of the "old timers" still like to argue against the simple arithmetics of the quantity theory and to overemphasize the qualitative aspects of bank credit.

Liquidity is the capacity to fulfill financial obligations.

It must be viewed with due regard to changes in the structure of liabilities (deposits instead of notes); to growth in the use of money substitutes (e.g., checks); and to changes in the composition of the banks' earning assets

In reality, the long-term trend of reduced cash holdings is not due to the improved liquidity of earning assets, but rather to market developments permitting the sale (shifting) of assets on a large scale. Liquidity -> shiftability

These trends point to the "relativity" of the liquidity concept. the cash ratio and the liquidity of earning assets, are determined by a bewildering number of factors. They will depend, for example, on such facts as the confidence of the public in the banks. Optimism or pessimism of cyclical character are even more important. Established standards of what is proper practice exert a great deal of "irrational" influence, too. Still more important is the general monetary organization of the country.

the very term "liquidity" is tied up with a currency system which limits the amount of available cash according to the "rules of the game."

The shiftability approach argues that there is no liquidity at all, since the whole system could not be liquidated, and overlooks the possibility or danger of some partial liquidation.
The fact that the total of the banks' assets cannot possibly have a book value greater than the total of their liabilities. Consequently Bank deposits should at all times be capable of buying the assets.
liquidity means preparation-for the avoidance of liquidation.
Liquidation = the process of closing a business, so that its assets can be sold to pay its debts
Liquidity != cash
A liquid structure never liquidates; only the illiquid one comes under the pressure of liquidation.
'Perfect liquidity" means that, for any length of time, all financial obligations are fulfilled without net liquidation of capital.
A liquid society has adjusted its obligations to the flow of its income. (Una sociedad líquida ha ajustado sus obligaciones al flujo de sus ingresos).
An open illiquidity (as opposed to a concealed illiquidity) means either a refusal to pay (i.e., collective bankruptcies, moratoria and foreign exchange controls), or the necessity of forced sales of bank assets, or both.

Parte 3 & 4:

- Liquidity, at first sight, is the capacity to fulfill financial obligations.
- Long-term earning power is a matter of provision for losses.

the volume of normal commercial transactions,disregarding seasonal fluctuations, is hardly ever subjected to violent changes. Speculative activities and the flow of savings into investments may dry up, but the basic commercial life which provides the consumers' current needs cannot stop.

The old experience that strictly commercial credits are always available in a modern banking community, and at a reasonable rate of interest.

changes in technology or consumption have a major liquidating effect on the banks' total credit.

An illiquid structure leads to a crash which a liquid one not only avoids for itself, but may actually soften for the rest of the community, by being able to "come to the rescue."

If bank credit is provided largely on short-term commercial lines, its total volume cannot exceed the demand for circulating capital proper, i.e., a sum commensurate with the amount of goods flowing to the market at prices at which they can be sold.

the, the total volume of circulating media is effectively limited by the observance of liquidity rules.

The liquid structure limits the possibility of fluctuations by not allowing the banking machine to supply more currency than is compatible with the volume of goods forthcoming, within a short time, at given prices.

A money market which serves largely long-term investment purposes is hardly capable of adapting its credit volume to changes in the rate of interest.

A liquid banking structure allows the central bank or the Federal Reserve system a substantial power over market fluctuations.

control over the money supply in itself is not sufficient to control price or income level fluctuations, since changes in velocity are usually beyond control. *Liquidity policy, on the other hand, has the advantage of indirect control over velocity, too.*

The shorter the period between the lending of funds and the repayment date, the less the likelihood of repeated use of the deposits.

liquidity means qualitative credit control checking the speculative activities of the boom which tend to increase the velocity of circulation.

Resumen History of monetary theory

Capital Allocation and Credit Policy

• Banking System creates and allocates means of payment.
• Purely Quantitative Approach doesn't measure the second function (saber cual es), but it is still important.
• Bank's lending power is discriminatory.
• Discrimination regulates volume of currency and these effects aren't always appreciated.
• Bank assets are a main factor in long and short term capital allocation.
• Liquid structure results in 'labor intensive' industries.
• Circulating capital strengthens medium sized businesses. Mammoth concern is favoured by illiquid system?
• Banks aren't the only factor in industrial structure but they have a big impact. Bank investments in a specific area result in other funds to that area.
• Liquidity doesn't necessarily help against advances in technology.
• Illiquid bank credit has helped inefficient units survive longer than wanted?
• Countries with industrial financing have seen booms in large scale units and monopolies. Countries that don't, allowed small units to survive longer, this doesn't directly affect bank branching.
• Cyclical influence of banking policy to long run developments is measured in 2 ways -
1. Banking system's choice of illiquid assets work themself out in cumulitative ways?
2. Intensity of 'speculative' activity is a matter of distribution of loans and investments by banks?
• Although the phenomena of the business cycle is commonly formulated in terms of a disequilibrium between the effective money supply and the flow of goods, or between the flow of savings and the volume of investments, etc., such quantitative formulas tend to overlook the fundamental chain of causation.
• It is the wholesale financing of abortive ventures with the aid of bank credit expansion which generates the boom. And it is the breakdown of these ventures and the sudden drying-up of the flow of bank credit which necessarily brings the boom to a halt.
• The purely quantitative approach neglects this allocative effect of the banking process. It does so by throwing overboard the principles of liquidity.
• The choice is among three possible policies:

1. the old-time ideal oflaissez-faire, directly controling the money supply by handing over the power of credit structure to political forces.
2. Stabilization but no way of eliminating the danger of illiquidity.
3. Lit no menciona la tercera.

Resumen Peel's Act of 1844 and the Currency and Banking Principles Controversy

Peel reconocio el problema de tener diferentes bank-notes a diferentes bancos:

1. Los bancos eran muy greedy y no tenian buenas politicas monetarias
2. Quebraban bastante seguido y con ello las bank notes correspondientes ya no valian dinero.

Decidió darle todo el poder de crear bank notes a un único banco, y tener un solo tipo de bank notes (monopolio de bank notes), efectivamente creando un banco central. Tooke was in favour of note regulation and of Bank of England monopoly. He agreed with those who cried: freedom of banking is freedom of swindling.

Bank notes became privileged currency instruments. They were there to:

- satisfy abnormal credit requirements
- To meet exceptional circumstances
- To act as a safety-valve in moments of monetary tension.

By giving one bank only the right to issue notes, it was given a means of action which other hanks did not possess, and also a means of control.

In summary, the countries currency became unified.

The Currency School, blindly following the suggestions put forward by Ricardo in 1823, advocated two measures:

1. The division of the Bank of England into two departments, an issue department and a banking department;
2. All note issues to be covered by coin or bullion, with the exception of a small quantity, for which the Bank should hold State bonds. (Commodity-backed money, aunque técnicamente estos notes no eran dinero de por sí)

AMBAS NORMAS FUERON ABANDONADAS HOY EN DIA

The unissued note reserve which the Bank of England uses for granting credits, that is to say its "margin of issue," formerly wholly inelastic, has now become as elastic as that of any other bank

FUERON ABANDONADAS Por que apoyaban ideas erróneas:

1. that bank-notes are money, whereas other credit instruments are not money
2. rises in prices (even when notes are convertible) are the result of an excessive issue of bank-notes (which are mistakenly regarded as paper money)
3. crises are the consequence of excessive issue

STUPID SOLUTION:

- (If there is an excessive amount of coin in circulation, gold will leave the country and the exchange rate of the currency will fall. The same symptoms will be manifest with "mixed" currencies, consisting of both coins and bank-notes.) (This conception of a "mixed" currency is also absurd since, even in the absence of bank-notes, coin is never the sole circulating medium.) Solucion = Once these symptoms appear, the number of bank-notes must be reduced.
- This will be achieved if the quantity of notes is strictly limited and if gold can only be obtained in exchange for bank-notes. To get gold, the public will have to use the notes in circulation, and thus their quantity will be automatically reduced.

MAIN OBJECTION:

- In a country such as England, with a highly developed credit system, the notes which the banks use to obtain gold are not drawn from the notes in circulation, but from the re-discounting of their bills at the central bank

ACTUAL SOLUTION:

- The only way to reduce the circulation, or rather to rectify an excess of credit, is to make credit dearer, that is to say to raise the discount rate.

No doubt it might be argued theoretically that current account deposits are the equivalent of bank-notes, that notes always come back to the bank if they are in excess

new laws put into force since the war give the Bank the right to issue notes without metallic cover in excess of the amount legally laid down whenever the need should arise. The unissued note reserve which the Bank ofEngland uses for granting credits, that is to say its "margin ofissue," formerly wholly inelastic, has now become as elastic as that ofany other bank

QUIZ QUESTIONS

1. Que es social securities y con qué analogía lo compara el libro?

Any government system that provides monetary assistance to people with an inadequate or no income.

2. Diferencia entre liquidity y liquidation

liquidity means preparation-for the avoidance of liquidation.

Liquidation = the process of closing a business, so that its assets can be sold to pay its debts

3. Diferencia de liquidity theory y shiftability theory

The **Liquidity** Preference **Theory** says that the demand for **money** is not to borrow **money** but the desire to remain liquid. In other words, the interest rate is the 'price' for **money**. **Liquidity** preference **theory** is a model that suggests that an investor should demand a higher interest rate or premium on securities with long-term maturities that carry greater risk because, all other factors being equal, investors prefer cash or other highly liquid holdings.

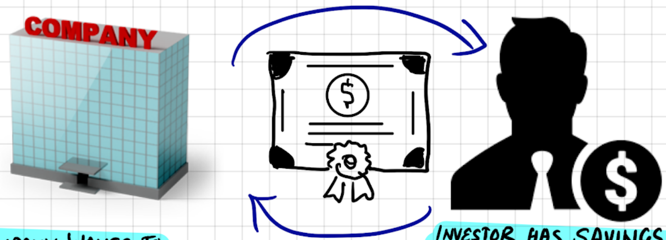
The shiftability approach argues that there is no liquidity at all, since the whole system could not be liquidated, and overlooks the possibility or danger of some partial liquidation.

Shiftability theory = In reality, the long-term trend of reduced cash holdings is not due to the improved liquidity of earning assets, but rather to market developments permitting the sale (shifting) of assets on a large scale.

4. Que es la perfect liquidity?

'Perfect liquidity" means that, for any length of time, all financial obligations are fulfilled without net liquidation of capital.

WHAT ARE SECURITIES?



COMPANY WANTS TO EXPAND AND NEEDS MONEY

INVESTOR HAS SAVINGS WHICH HE WANTS TO INVEST

A Security is tradable financial assets, can be traded over the stock exchange.

SECURITIES

WHAT

FINANCIAL INSTRUMENTS

EQUITY

STOCKS

OTHER

DEBT