

PERIODIC LIQUIDITY CRISES: THE REAL CAUSE AND CURE

By Robert de Fremery

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The last international liquidity crisis contributed heavily to the rise of Welfare States, Naziism and World War II. What will be the aftermath of the current crisis that is worsening by the day? Does our government have the courage to explain publicly the real cause of these recurring crises?

There are glimmerings of hope. George Mitchell of the Federal Reserve Board recently expressed concern about the liquidity problems that have arisen from "the growing business of borrowing short and lending long—the transformation of liquid claims into longterm credits by depository intermediaries ... financial intermediaries have implicitly promised more liquidity, yield and accommodation to their customers than they can readily deliver."*

However, Mitchell offers no constructive plan to avert

* Statement before Committee on Banking and Currency, May 24, 1966

the crisis. Instead he says: "In the short run, we have to quell the hysteria and break the paralysis that seems to be gripping some participants in and observers of the financial scene. The financial structure is essentially resilient and well managed, and there exist governmental mechanisms established for the very purpose of easing adjustments that must come in the wake of shifts in demands for goods and for financial services ... the situation hardly warrants the crisis atmosphere that has developed in some quarters, or the overreaction by portfolio managers which threatens to curtail housing activity unnecessarily sharply."*

Creating a Better System

Soothing words about the effectiveness of "governmental mechanisms" to deal with a liquidity crisis will not allay the fears of those who know its cause. There is only one thing that will allay those fears and that is to put our depository intermediaries on a sound basis. To do this we must convert the existing volume of bank credit into actual money and require banks to stop the unsound practice of borrowing short to lend long. ...

Under this stabilized system banks would have two sections: a deposit or checking-account section and a savings-and-loan section. The deposit section would merely be a warehouse for money. All demand deposits would be backed dollar for dollar by actual currency in the vaults of the bank. The savings-and-loan section would sell Certificates of Deposit (CDs) of varying maturities—from 30 days to 20 years—to obtain funds that could be safely loaned for

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comparable periods of time. Thus money obtained by the sale of 30-day, one-year and five-year CDs, etc., could be loaned for 30 days, one year and five years respectively—not longer. Banks would then be fully liquid at all times and never again need fear a liquidity crisis.

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Some believe it is too late to make such a radical change in our banking system. They forget the present system is so unsatisfactory that far more drastic plans for international monetary reform are being considered right now. The tragedy is that none of the other proposed plans comes to grips with the basic cause of our troubles. They all assume the soundness of borrowing short to lend long. They all involve a further loss of each country's financial sovereignty. Some want this and have been working toward this end ever since the last international liquidity crisis in the early 1930's. They sincerely believe liquidity crises can be averted by closer cooperation of all central banks. This is the same unsound thinking that originally led to the formation of all central banks. It is the thinking that led to the creation of our so-called "panic-proof" Federal Reserve System that gave us more inflation and deflation than ever before.

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The United States is at an important turning point in its history. Until now we have been following the advice of those who persist in defending the practice of borrowing short to lend long. Are we going to continue—or are we going to admit that we have been led astray? Shall we give up our financial sovereignty, or shall we at long last provide ourselves with a reliable dollar? Time will tell. But of one

thing we can be certain: A banking system based on the unsound practice of borrowing short to lend long is destined for oblivion. The sooner it goes—the better for mankind.

Borrowing short and lending long has been one of the classical recipes for vulnerability.

—Harold Wilson, Prime Minister of
England, 4/14/65

The inconsistency of borrowing short and lending long has constituted a basic weakness in the banking system and has subjected long-term assets to violent deflation when banks have had to sell these assets rapidly to meet the demands of time depositors.

—W. Randolph Burgess,
The Reserve Banks and the Money Market

As the world's banker, the U.S. now is indulging in a practice which most bankers consider ruinous: borrowing short, while lending long.

—Barrons, "The World at Work", 9/12/60