Bill Gary's

PRICE PERCEPTIONS

Technical Update

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The Greatest Shortage – Liquidity !

"Liquidity: The ability of an individual, group, business, or any organization to meet its financial obligations."

- Dictionary of Modern Business

The current decade has experienced one shortage after another. There was a shortage of lumber during the housing boom, a shortage of copper as the Chinese economy grew, a shortage of oil as global demand exceeded supply, and a food shortage as the world consumed more than it produced. Now, there is a new developing shortage of historic importance... *Liquidity!*

Liquidity has become a focal point of the global economy in recent months... Last summer, the Federal Reserve began reducing interest rates to inject liquidity into the banking system due to the sub-prime crisis... By fall, they opened their lending window to Wall Street investment firms to shore up liquidity needs... This spring, the Fed guaranteed assets as an incentive for J P Morgan to take over Bear Stearns... And, this week Congress agreed to invest billions in Fannie Mae and Freddie Mac and insure up to $300 billion in mortgages to free up liquidity for the housing market. What is this thing called liquidity? Why is there such a shortage? Who's got it? How can we get it?

Like so many things in the study of economics, liquidity is not a well defined term. A bank may be considered highly liquid one day, but illiquid the next, if too many depositors suddenly demand their savings. Two years ago, consumers viewed their home as the most ready source of liquidity. Today, consumers measure liquidity as the amount of "unused" credit on their Visa card. Alfred Malabre in his book, *Beyond Our Means*, described liquidity as similar to air that inflates a balloon... If the balloon has only a couple of holes, it can stay inflated by pumping in more air, the inflow counterbalances the outflow. However, when there are numerous holes and new ones are appearing every few minutes, even vigorous pumping cannot provide sufficient inflow to prevent its collapse.

Using this analogy, it's easy to visualize that the Fed pumped up the balloon (economy) too much over the past decade. Holes (financial stress) began to appear during the dot-com and housing bubbles. Vigorous pumping (money printing) only counterbalanced the outflow (bad debts). Now, so many holes are developing the balloon is beginning to contract even though the rate of pumping (Federal bailouts) has never been greater.

It appears loan defaults and bankruptcies are developing at such a fast pace the Fed can no longer print enough money to guarantee continued economic expansion. *The greatest shortage of all may prove to be liquidity rather than copper, oil or food.*

Bill Gary