

## *The Economy in Perspective*

*Water, water, every where,  
And all the boards did shrink;  
Water, water, every where,  
Nor any drop to drink.*

Samuel Taylor Coleridge—  
*The Rime of the Ancient Mariner*

Market liquidity dominates the financial news these days, and for good reason. Liquidity conditions influence the ability to execute financial transactions quickly and at prices that fairly approximate true value. In illiquid markets, trading takes more time, involves more risk, and becomes more expensive. Real economic activity can fall victim to illiquid financial markets if potential investors fear they will be unable to sell the securities they own at a reasonable price in the future. If enough investors pull back from a market, its ability to support economic activity is impaired.

How can one gauge the fair price of a financial instrument at a given moment? After all, isn't market trading itself a process of price discovery through which supply and demand conditions are revealed? In highly liquid markets, small differences between "bid" and "asked" prices attract additional buyers or sellers, narrowing the price spread. There is no foolproof way to measure market liquidity, but many observers contend that some financial markets have become less liquid during the past few months than in the previous several years.

Why have these markets dried up? Investors' willingness to take on risk has most likely changed. Pension fund managers, insurance companies, and households may simply have reined in their appetite for certain kinds of investments, even if the riskiness of those projects has not changed. Moreover, investors who have suffered a recent loss of wealth have less ability to bear risk. Another concern is the riskiness of the projects themselves, such as the questionable profitability of building another steel mill in Malaysia.

There is also a micro-market explanation. Many securities firms make markets in the securities they underwrite. Think of such a firm as a department store, balancing its cost of inventory financing with its desire to carry a wide selection of merchandise and offer a generous return policy. Large securities firms have likewise become

important dealers in various markets, acting as both buyers and sellers to keep markets liquid. At reasonable trading volumes and financing costs, this activity encourages more trading and leads to greater overall profit for the firm. But securities dealers, like department stores, dislike holding inventory that does not move briskly. In the last few months, as demand for certain securities has declined sharply, some dealers apparently have become less willing to make markets in them or to hold much inventory. These firms also worry about their own risk exposure. The resulting reduction in market liquidity further curbs some customers' readiness to purchase these instruments in the first place.

Monetary policy operates principally by adjusting the amount of base money available in the economy; base money consists of cash and bank reserves. By supplying more base money, the Fed can push short-term interest rates down and give banks more leeway to expand their lending. But short-term U.S. Treasury rates have declined considerably on their own for the past few months, as investors have shortened the maturity of their holdings and rushed into assets that they consider safe. The flight to quality that is so evident in today's financial markets does not result from restrictive monetary policy. It is the product of individual decisions made by thousands of businesses and millions of households in response to their changing views about risk and reward. The Fed can enlarge the banking system's capacity to take up the slack created by less liquid capital markets, but it cannot alter the underlying risk profiles of the real investment activities that capital markets had previously been funding.

Once people are satisfied that they've regained their ability to appraise the risks associated with various forms of investment, more markets will begin operating smoothly again. Of course, the relative cost of financing could become so great that certain kinds of projects are no longer profitable, but that would not necessarily be a bad outcome. In the past, similar projects obtained financing only because of unreasonable risk assessments. Monetary policy must, of course, not allow credit availability to evaporate unduly. On the other hand, it would be counterproductive to pour water on a drowning man.