Excess Liquidity

September 22, 2011

I live on a ridge overlooking the valley in which Hartford, Connecticut, is located. My house is located on one of the highest points on the local public water system. On a recent evening a neighbor called to ask whether the water was out. She had no pressure. I checked my water and found that I not only had no pressure, I had a great sucking sound as water was pulled out of my house by gravity.

I told her not to worry. It was probably just one of our nearly annual outages caused by either a drunk driver taking out the power on the mountain road or a mechanical failure in the local pumping station. I assured her that the water company had adequate instrumentation to detect the problem, and would have a crew out to resolve it in two or three hours.

Four hours later, there was still no water. But, I went to sleep fully expecting that the water would be on by morning. In the morning, however, there was still no water. I called the water company and was told that they did not discover the outage until five hours after we had noticed that there was no water. For five hours, their instruments kept telling them that they were experiencing an extraordinary demand for water from my neighborhood, and they responded to that demand by steadily increasing the pressure in the system. Only when they were unable to maintain the pressure did they send a team to the pumping station to find out what was going on. It took another hour or two to find that there was a water main break in the foothills below my house. For six or seven hours the water company was flooding a lower neighborhood, washing away roads, driveways, yards, etc. The excess liquidity flowed down hill.

Once the problem was properly identified, it took only a few hours to correct it. But it took several days to clean up the damage caused by the excess liquidity.

The Federal Reserve has the same situation that my water company had. There is a massive leak in the financial system caused by the undervaluation of the Chinese yuan. The Fed expands liquidity to support the system as needed according to their instruments. But the leak causes hundreds of billions of dollars each year to leak out of the system to China, other undervalued Asian economies, and to the other countries that supply raw materials, capital goods, and luxury goods to China or their vassal or tributary states. Some of the excess dollars are returned to the New York money markets, where the Fed's instruments fail to recognize them as money because they are "custody" dollars (currently $3.47 trillion). But, more than half of the excess dollars remain overseas (currently $4.08 trillion) and flood foreign banking systems and money markets with excess dollar liquidity. In both New York and the developed and developing worlds, the excess liquidity floods lending markets with short term funds, creating bubbles, inflating real estate prices, inflating commodity prices, and inflating emerging stock markets, giving them an extraordinary burst of growth that appears to be low risk.

But, the Fed's instruments and measuring systems are inferior to those of my water company. The system failure is not discovered in hours, days, or even months. It is not discovered even in years, because the engineers of the Fed are arrogant and refuse to believe that there could be anything wrong with their instruments. If the pressure is too low, pump in more liquidity. If flooding the neighborhood, the country, and the world is not sufficient, flood the known universe.

Edward Guay
Principal
Wintonbury Risk Management
Bloomfield, Connecticut
Wntnbry@aol.com