

## Liquidity or Liquidation

By Sam Vaknin, Ph.D.

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Large parts of the world today suffer from a severe liquidity crisis. The famed globalization of the capital markets seems to confine itself, ever more, to the richer parts, the more liquid exchanges, the more affluent geopolitical neighbourhoods. The fad of "emerging economies" has all but died out. Try telling the Macedonians about global capital markets: last year, the whole world invested 8 million USD in their poor country. Breadwinners earn 300 DM a month on average. Officially, in excess of one third of the workforce is unemployed. Small wonder that people do not pay their bills, employers do not pay salaries, the banking system has a marked tendency to crash every now and then and the average real default rate is 50%.

Illiquidity erodes the trust between the economic players. Such trust is a precondition to the existence of a thriving, modern economy. We all postpone the gratification of our desires: we save now and consume later, for instance or we sell goods or services and get paid a month later. Such postponement of gratification is at the heart of the economic machine of the new age. It cannot be achieved, however, if the players do not trust each other to fulfil their promises (to pay, for example). Alternatively, the state can instate an efficient court system, aided by active law enforcement agencies. Keeping promises can be imposed to counter the natural tendency to ignore them.

The countries in transition lack both: liquidity necessary to keep one's monetary word and the legal system to force him to do so if he reneges. Small wonder that solutions are actively being sought by all involved: the business community, the state, the courts and even by consumers.

In this article, we will describe a few of the global trends. The trends are global, the reaction is world-wide because the problem is global. Bouncing checks have become a household reality in places as rich as Israel, for instance. The mounting crisis in Southeast Asia foreshadows bankruptcies and delinquencies on a chilling scale.

The simplest method is to revert to a cash economy. Payments are accepted only in cash. This, naturally, slows the velocity of money-like products and diminishes their preponderance, obstructing the expansion of economic activity. An even more malignant variant is the barter economy. Goods and services are swapped on a no-cash basis. It is money that generates new value added (by facilitating the introduction of new technology, to mention but one function). In the absence of money, the economy stagnates, degenerates and, finally, collapses because of massive mismatches of

supply and demand aggregates and of the types of goods and services on offer and demanded. Still, this system has the advantages of keeping the economic patient alive even following a massive liquidity haemorrhage. In the absence of barter economy, the economy might have ground to a complete halt and deteriorated to subsistence agriculture. But barter is like chemotherapy: it is good for a limited period of time and the side effects are, at times, worse than the disease.

In many countries (Georgia, to mention one) defaults are prevented by demanding prepayment for projected consumption. Let us take the consumption of electricity as an example: many heavy users and numerous households do not pay their bills at all. To disconnect the electricity is an effective punitive measure but it costs the electricity company a lot of money. The solution? Programmable Electronic Meters. The consumer buys a smart card (very similar to phone-cards). The card allows the buyer to use a certain amount of prepaid electricity and is rechargeable. The consumer pays in advance, electricity is not wasted, the electricity company is happy, the tariffs go down for all the users. Prepayment does have a contracting effect on the demand and usage of electricity - but this is welcome. It just means that people use electricity more efficiently.

A totally different tack is the verification approach. The person making the payment carries with him a card which confirms that he is creditworthy and will honour his obligations. Otherwise, the card also serves as an insurance policy: an entity, not connected to the transaction, guarantees the payment for a fee. This entity is financially viable and strong enough to be fully trusted by the recipient of the payment.

This market in credit guarantees is more developed in the USA (where credit cards have overtaken cash and personal checks as a mode of payment) than in Western Europe. But even in Europe there are credit card equivalents which are very widespread: the Eurocheck card, for instance, is really a credit card, though it usually comes with physical checks and guarantees only a limited amount. One must differentiate the functions of a debit card (with direct and immediate billing of a bank account following a transaction) from those of a credit card. The latter allows for the billing of the account to take place in a given day during the month following the month in which the transaction was effected or converts the payment into a series of instalments (within the credit limits of the cardholder as approved by his bank). But in both cases, the guarantee is there and is the most predominant feature of the system. Such cards seem like a perfect solution but they are not: the commissions charged by the card issuers are outrageous. Between 2 and 10 percent of the payment made go to the pockets of the card issuers. Cards get stolen, forged, lost, abused by their owners, expire. But with the advent of new technologies all these problems should be solved. Electronic POS (point of sale) cash registers, connected through networks of communication, check the card and verify its data: is it valid, is it presented by the lawful owner, was it stolen or lost, is the purchase within the limits of the approved credit and so on. Then, the billing proceeds automatically. Such devices will virtually eliminate fraud. The credit card companies will guarantee the payments which will be subject to residual crime.

Another fast developing solution is the smart card. These are cards similar to phone cards and they can be charged with money in the bank or through automatic teller machines. These cards (in wide use in Belgium, Austria, Germany and many other

countries) contain an amount of money which is deducted from the cardholders account. The account is billed for every recharge. The card is the electronic (and smart) equivalent of cash and it can be read (=debited) by special teller machines in numerous businesses. When payment is made, the money stored in the card is reduced and the recipient of the payment stores the payment on magnetic media for later delivery to his bank (and crediting of his account).

A more primitive version exists in many countries in Eastern Europe: depositors receive checks exactly corresponding to the amount of money deposited in their account. These checks are as safe as the banks that issued them because they are fully convertible to cash. They are, really, paper "smart cards".

Credit cards and (more cheaply) smart cards are a way to restore confidence to a shattered, illiquid economy. Macedonia should consider them both seriously and encourage them through the appropriate legislation and assistance of the state. For Macedonia, the choice is to be liquid or, God forbid, to economically self-liquidate.

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NASD Bid & Ask

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Published April 2000

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Nasdaq and the Over-the-Counter Bulletin Board (OTCBB) trade on a Bid and Ask format. Bid is the price an investor is willing to pay for a stock. Ask is the price that a shareholder is willing to sell the stock.

The spread is the monetary difference between the Bid & Ask price. A stock with a bid of ten cents and an ask of twenty-five cents has a spread of fifteen cents. If the spread is wide, for instance a bid of twenty-five cents and an ask of two dollars, few shares trade. If all other factors are equal, a narrow spread increases the stock's trading volume. You can use the spread to regulate the trading volume.

If there's a Bid, without an Ask, the share price is likely to move up. This is a situation where the buyers are seeking to form a market. If there's an Ask without a Bid, the stock will collapse.

Trading volume equals liquidity in a stock. Most shareholders are locked into Penny Stocks. They can't sell at a profit, without depressing the price of the stock. To create the illusion of liquidity, some companies do round robin or wash trades. The insiders trade the stock among themselves. The goal is to attract investors by showing high volume trading. Stock brokers love wash trades. However, the practice doesn't create a strong shareholder base.

The issued stock of any company can be divided into insider shares and the float. The public owns the shares in the float. If you see a high volume stock, check the float. If it's small the odds favor wash trading by the insiders.

Few buyers buy stock. They buy the right to own the stock from their brokerage firm. Their right is reflected on their monthly brokerage account statement. Essentially, their right is an option issued by the brokerage firm to the client. It qualifies the client for share price appreciation, if the stock moves up. Of course, to benefit from share price appreciation, the shareholder must sell their stock (option). Few public shareholders sell in an upward moving Market.

Unless the buyer becomes a registered shareholder of the company, the buyer doesn't own the stock. This fact allows professionals to sell nonexistent stock. The sales are short sales relying upon the shareholder accepting the brokerage firm's account statement as an option on their stock. The short sales add to the float. The short sales depress the company's share price.

As a public company trading on the OTCBB or Nasdaq, you must manage your Bid & Ask price. A well-run public company ensures shareholder liquidity. OTCBB companies should offer liquidity without creating the illusion of a large trading volume. The company must make short selling difficult. The company's share price must slowly move up. There's a time to build the company and its shareholder base. There's a time to promote the stock. If you lack the right shareholder base, your stock promotion will end with a major decline in your share price.

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