Central banks head off a liquidity crisis

We live in amazing times. The graph of US money growth is pointing upwards at an unprecedented rate. The graph of the US budget deficit is almost vertical. The last three months has seen the issue of over $ 2 trillion of additional Treasury bills, short term loans for the US government. No wonder the financial markets are in melt up.

The Fed’s latest figures show annualised M2 money growth at 40% for the last three months, a record level. State debt has surged by $2.06 trillion between March and May.

Remembering last time when Central banks starved markets of cash and left the banking system and corporates to plunge into financial reconstruction or bankruptcy for want of liquidity, the Central Banks led by the Fed have this time done the opposite. So far so good – companies have borrowed money instead of going bust,and banks have plenty of cash to lend.

The problems this poses come later. There is first that it must be a bridge to recovery, not to insolvency. Delaying bankruptcies would not be much of a success if we end up entering a credit meltdown when too many companies fail to repay their money on time.

There is also the issue of inflation. So far we just have asset price inflation. If more of this money gets into the bank accounts of companies and people who want to spend it rather than invest it in financial assets, that could prove more generally inflationary. Then Central Banks have difficult choices to make. Putting up rates to throttle back credit is the usual response to cut demand and stop overheating. That in turn means triggering the delayed bankruptcies of the over borrowed companies.

The happy answer is for the Fed and Central Banks to gently throttle back now they have stopped a liquidity crunch. The commercial banks have a lot of work to do deciding realistic and sensible schedules for repayment of loans, and working with business on who has a sustainable business model worthy of support and who does not in these new and difficult times.