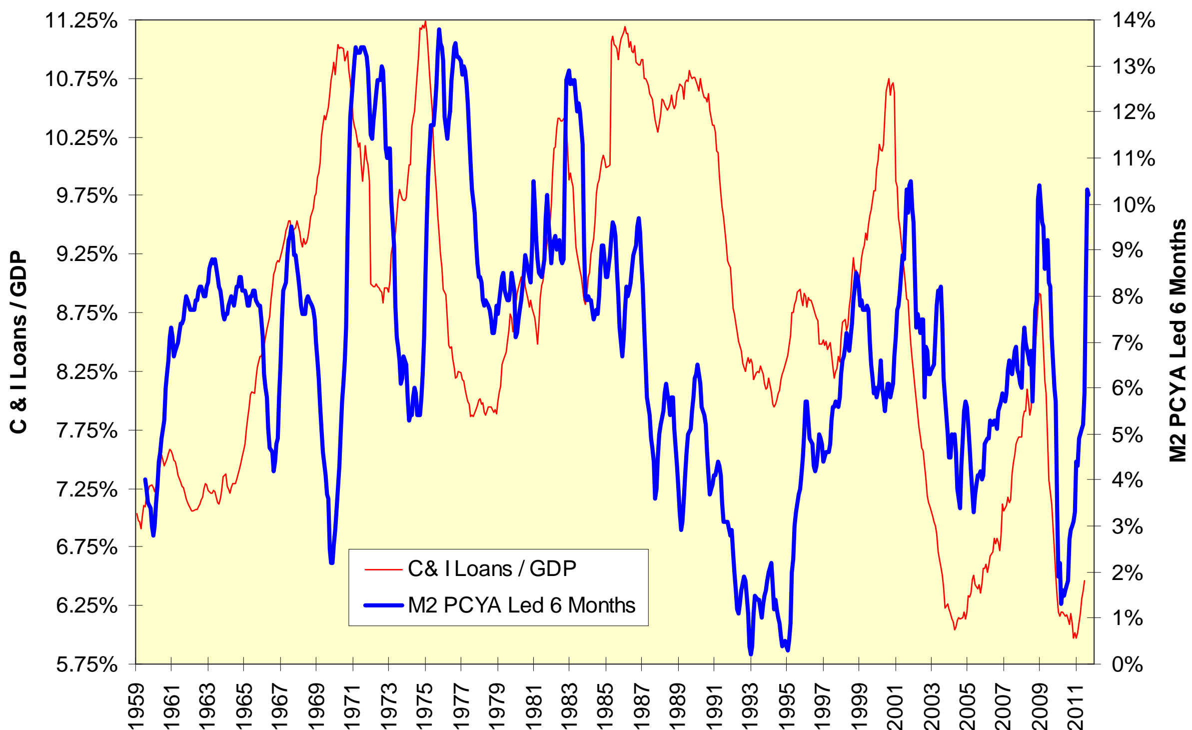
Commercial Lending On The Rise

Too much of what passes for economic policy is really nothing more than a cargo cult. Instead of dancing at the end of the runway and taking credit for the planes landing, policymakers err in believing their actions determine outcomes when the events would have happened anyway or have happened in spite of their actions. Still, as the human mind rejects randomness and expects better answers from economists than, "[stuff] happens," we kind of accept the notion someone is in control.

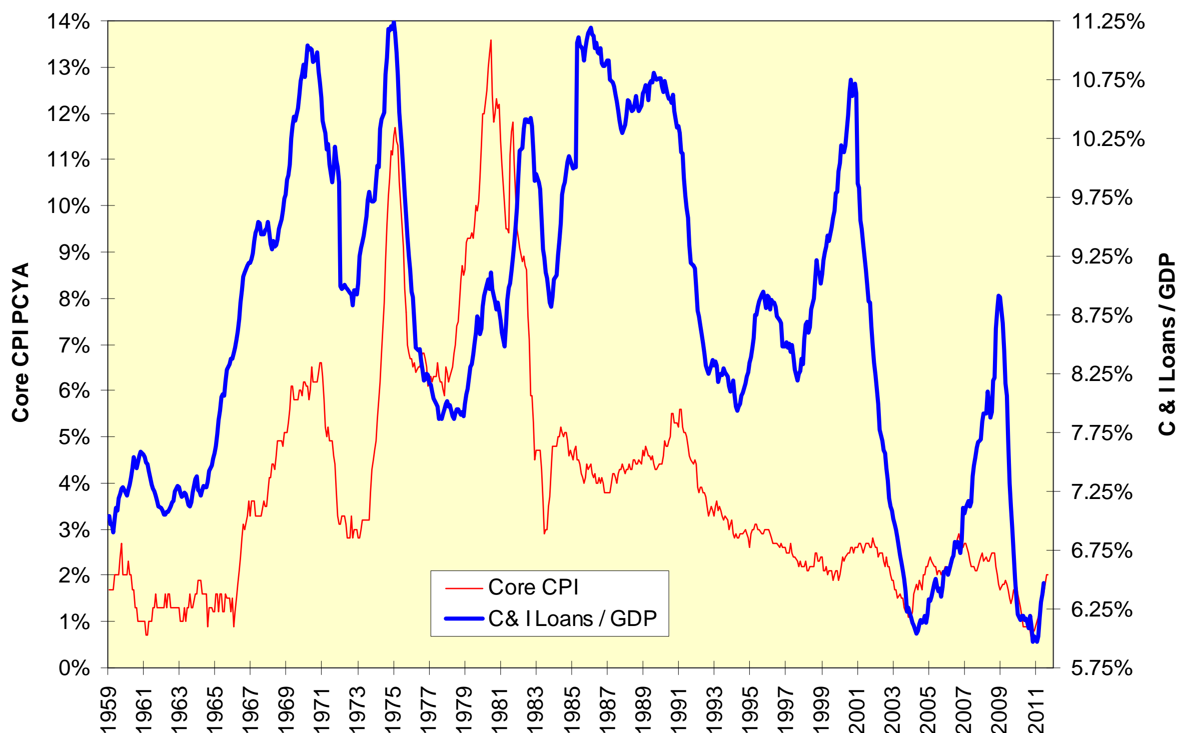
As an aside, I have been convinced for years you could place an absolute impostor at the head of the Federal Reserve and, per the 1979 classic Being There, the financial world start deifying the buffoon.

Regardless, as we learned way back in Economics 101, the fractional reserve banking system creates money via lending. Commercial and industrial loans have increased from 5.98% of GDP in January to 6.47% at the end of June, the last GDP datum available. In absolute terms, they are up 9.88% on a year-over-year basis through August. The money supply is up a rousing 10.2% on an annual basis. As lending leads the money supply by six months on average, we should see continued upward pressure on M2 growth.



Offsetting this is a decline in velocity, or the ratio of GDP to money; the measure is at its lowest level since 1977, indicating all of this money is very ineffective at stimulating output and employment as many of us have noticed. In addition, consumer credit is declining as a percentage of GDP. These offsets should help keep inflationary pressures in check.

If and when the core CPI does start to rise, we should see a burst higher in lending; this happened in late 2003 and again at the end of 2010. The mechanism here is simple: Higher inflation readings encourage corporate borrowers to secure credit before interest rates advance further.



In the past, the Federal Reserve acted to squelch this self-reinforcing cycle by raising short-term interest rates; this certainly happened in 2004-2006 with the string of seventeen consecutive rate hikes, none of them effective in deflating the credit bubble that burst in 2007. Now we have a pledge, not of allegiance to the flag of the United States of America and to the Republic for which it stands, but rather one not to raise short-term interest rates between now and sometime in 2013.

Poppycock, nonsense and balderdash: Once borrowers sense the Federal Reserve is behind the curve in fighting inflation, they will scramble like mad to lock in lending while lenders will start disconnecting their phones. Market rates will rise over the Federal Reserve's targets and assets will get re-priced, swiftly and unceremoniously, to those market expectations.

If this happens, and it is still an "if" and not a "when," it will not be pretty. The suppression of interest rates has consequences; all market manipulations do, and we will once again pay a price for pretending the witch doctors dancing on the runway can control when the planes will land.