Commercial Lending And Inflation

Once upon a time (is that a catchy opening, or what?) economics students were taught about the fractional reserve lending system and how it affected the amount of credit available to businesses and individuals. It was neat and tidy: Whenever the central bank got a magic tingle going in an unmentionable place and wanted to tighten credit, it sold Treasury securities to member banks that then had less money to lend and credit shrank.

Too bad for the central planners this started to break down with the elimination of Regulation Q interest rate ceilings in the early 1980s and then with the development of notional finance and finally with the wonderfully named "shadow banking system." I am amazed the black helicopter crowd has not gotten around to something so conspiratorial-sounding as shadow banking; maybe they have too much on their plate already.

Money Supply And Commercial Lending

The historic pattern of commercial and industrial lending normalized to GDP leading year-over-year changes in M2 by 12 months broke after the initiation of QE2. While normalized lending has increased from 4.79% in November 2010 to 6.82% in December 2014, M2 growth has declined from 9.7% in November 2011 to 6.1% in March 2015.

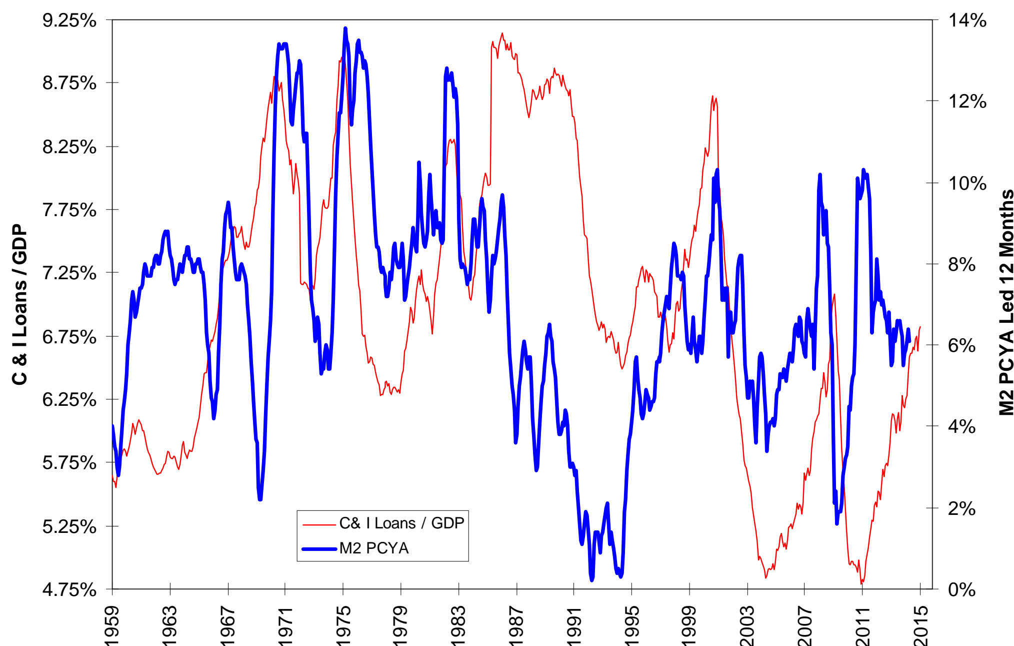
Much of this has been attributable to the credibility and self-fulfilling nature of Federal Reserve forecasts for low short-term interest rates during the QE era. This kept demand for cash balances high and depressed both core CPI and M2 growth. We are now almost two years past the first hint of QE tapering and yet there still is no priced-in date for when short-term interest rates will rise.

The observed rise in normalized commercial & industrial loans and the expansion of consumer credit have not led to inflationary growth in the money supply or to rising core CPI; too much of the base money created in QE simply remains on the Federal Reserve's balance sheet receiving interest on excess reserves.

The understandable fear is if higher rates materialize, however, demand for cash balances could fall and M2 growth could expand rapidly as part of the classic consequence of fractional reserve lending. However, the textbook linkage between normalized commercial lending and core CPI has not been observed in the data since those aforementioned developments of the 1980s.

While the velocity of M2 at 1.5352 is higher than the post-1959 low of 1.5310 reached in 2014:Q1, the advance is only marginal and nothing yet suggests an imminent upturn. The combination of low velocity and relatively low M2 growth implies continued slow growth in GDP.

M2 And Commercial Lending



Money Supply And Credit

One reason why the forecast for higher short-term interest rates is not as credible is the post-1959 high in normalized consumer credit. The combination of stagnant personal income growth and low nominal interest rates has enabled this measure to grow from an already-high base. Higher debt service costs will crimp consumer spending and force the resumption of lower short-term interest rates.

This downward-pointing governor on interest rates has been operating since, you guessed it, the early 1980s. Maybe we should stop acting surprised by it.