Why do we need to monitor liquidity

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Liquidity means the total supply of money in the country. The total money that people and governments hold. If there is higher liquidity, then it means people have more money to spend. How do you determine how much money(liquidity) should be there in the country?

The Central Banks (part of government) and the commercial banks have the ability to create money in the local currency. However, it is the government (Central Bank) only, who keeps track of the money supply or liquidity in the country.

In theory, the there is no limit as to how much money a country can create, i.e. any country can create as much money as it wants. Then the question arises - when everyone (including the government itself) is always asking for more and more money – why don't the governments create unlimited quantities of money?

The answer is simple. The value of the currency reduces if more money is issued (it is inversely proportional to the quantity of money). This means that the purchasing power of the currency falls as more and more money is created.

How does the 'value of money' or 'purchasing power' work? Let's understand with an example…

Say, you have 1000 bucks and you can buy a television with this money today. Now, in a few days, the government releases more money and there are many more people who are wanting to buy that same television. So, the price of the television rises to 1100 bucks.

This rise in the price is called **inflation**.

(You may argue that the price of television may have risen due to other factors such as demand–supply gaps or the seller chasing higher profits. Let's assume we keep all such possibilities away and consider the case of increased money supply only.)

What happened here is that **the cost** of television **remained the same** but the value or the purchasing power of money reduced. Now, you need 100 more bucks over and above the old 1000 bucks to buy the same thing. In such a situation, we say that the purchasing power has dropped by 10% or in common terms – the **rate of inflation** is 10%.

Inflation leads to reduction in the purchasing power (value) of money/currency. Year on year you have to spend more and more money to buy the same thing.

But, what's the harm in high liquidity or inflation?... we can easily create more money, give it to everyone and compensate for the 10% rise!

If government issues more money, the purchasing power drops further and the television keeps getting more and more expensive. This is the problem with liquidity, the more and more liquidity we create, the more and more inflation rises.

What happens when inflation reaches higher rates, say 50%. At 50% inflation the price of television becomes 1500 bucks. This is a large difference. If you had 1000 bucks, what would you have done? – kept the 1000 bucks in cash or bought the television immediately!

The high rate of inflation changed your behaviour. What if, you had more money, say 5000 bucks. Would you have an itch to buy one more extra television and hoard it? This behaviour is called as **hoarding**.

What will happen if many people start hoarding the television? The price of television will quickly inflate past 1500 and rise further and further. This is called as **hyper-inflation**. In this situation, governments have to create more and more money so that people can afford the necessary things. But everything keeps inflating quickly.

In **hyper-inflation**, no one in the country wants to keep cash (primary currency) that is losing value or purchasing power. Everyone wants to keep their money in other forms, such as hoarding products, investment assets or foreign currencies.

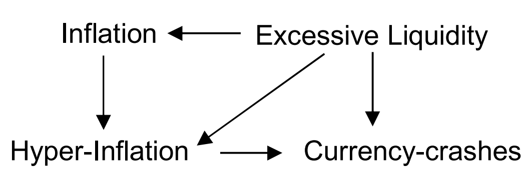
In extreme circumstances, **currency crashes** can happen! In the international currency market when everyone sells off because no one wants to hold or accept the particular currency – currency crash happens. While in the domestic economy, the government has to reissue fresh currency or higher denominations. Sometimes they have to shift the domestic market entirely to some other foreign currency that is more stable.

With the discussion so far, we can say that excessive liquidity can lead to hyper-inflation, that can lead to currency crash in both domestic and international markets. Liquidity monitoring becomes more important when we know that the commercial banks also create money (refer Thesis) and they do not bother about their impact on liquidity or inflation at all.

Why do we ignore liquidity? Liquidity is a subjective parameter and it is very difficult for the Central Banks to determine how much liquidity is helpful for the country and how much is harmful. Because of the subjectivity in liquidity-based decisions, governments try to focus on inflation directly. Inflation is easily measurable; it is measured regularly and it is easier for market participants to understand inflation-based targets.

Problems with inflation focus: Targeting inflation helps in controlling inflation and hyperinflation; but is it effective in controlling currency-crashes? Another problem with inflation targeting is that inflation can shift to other assets that are not controlled. For example, investment assets may start inflating compared to consumption assets when Consumer Price Inflation is targeted (refer Thesis).

Figure: Impact of liquidity



Focusing on liquidity alone has problems too: Sometimes, it takes too long for the liquidity to become visible in inflation; because every government tries to keep inflation as low as possible. Therefore, many governments abstain from creating new money or deficit financing. Also, they try to make more and more information public in time, so that the hidden information does not build up a crash later (refer Defects in Equilibrium). This way the information trickles into the market and economic health indicators start showing warning signs in time; saving the economy from diseases.

In my opinion, targeting inflation alone cannot control the situation of excessive liquidity. Overlooking liquidity may someday lead to unexplainable currency crashes in the international markets. It is a good idea to target both inflation and liquidity.