Liquidity and Inflation Thesis

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Abstract: We have been using incomplete definitions of inflation and liquidity. This article shows what is missing. Also, the unaccounted liquidity is leading to the inflation of investment assets instead of consumption assets.

Economics says high liquidity leads to high inflation. Then in last 50 years, why inflation has not risen as much as liquidity.

Temporary Money supply and Liquidity

First of all, we do not know how much liquidity has risen in past 50 years because we have been using incomplete definitions. Economists use **regular money** released by the government or the Central Banks to calculate liquidity. They are completely unaware of the money released by Commercial Banks.

Commercial Banks create **temporary money** by lending more than what they borrow. For example, if a bank has a deposit of 10million, it can lend 100million. Where does 90million come from? This 90million is temporary money that the commercial banks can create. It is temporary because it is a loan and the borrower has to return it to the bank.

This temporary money has become 'regular money in circulation' because the commercial banks lend fresh money before the old money is returned. For example, let's say a bank lent 90million in temporary money in year 2001 for 10-year terms. Similarly, it lent another 90 in 2002 and so on. The total outstanding of temporary money in 2002 comes to 170=90+90-10(-10 is the repayment of 2001 loan). Similarly, by 2003, the total temporary money in circulation becomes 240million (170+90-20) and so on.

On paper, the temporary money is not used in any calculations as it is extinguished by the commercial bank after the loan is repaid. But in practice, the total cumulative sum of temporary money is rising every year and it is no different from 'regular money in circulation'.

How do we calculate liquidity now? What is the real amount of money in circulation?

Liquidity and Inflation

Based on the example above, I can easily say that in last 50years liquidity has risen several times.

If liquidity has risen several times, it should have been visible in inflation. But comparatively consumer price inflation has risen only marginally – just a couple of times!

Why liquidity is not visible in inflation?

We are using incomplete definition of Inflation as well. We look out for inflation in consumer prices and wholesale prices of various goods. I call these goods '**consumption assets' –** assets or products that you buy for consumption – such as food, vegetables, clothes, home appliances, houses etc. Economists all over the world, only look at consumption assets and not at all kinds of assets for the calculation of inflation.

There is another set of assets that people buy – **investment assets**. Once people have met their consumption needs, they start saving money. This savings money goes into investment assets – or the assets bought for the purpose of investments – such as property, gold (bullion), stocks or shares, bonds etc.

As per my observation, instead of consumption assets, it is the investment assets that are inflating so much. Investment assets have risen several-several times and can easily be compared with the rise in total liquidity or the total money in circulation.

Recommendations:

1. Including inflation of 'investment assets' into the traditional definition of **inflation** can give us a clearer picture of inflation as well as liquidity.
2. The definition of **liquidity** also needs to include 'temporary money' created by so many commercial banks.

Appendix

1. Inflation of Cash and Currencies

Once people have exhausted all avenues of investments, they do not have anywhere to invest. They sit on large amounts of cash or use currencies as investments. Many investors and large exporters keep large sums of a few selected currencies for very long.

Another problem with currency market that it is relative; it means that if someone wants to buy one currency, he will have to sell another. So, the currency that is bought will inflate and the currency that is sold will deflate at the same time.

Calculating prices of currencies is very complex. People do not look at the temporary money supply to calculate true price of their investment. Currencies are vulnerable to rumours and big crashes. Hence, the governments are under pressure to not make any changes to the regular money supply or people may start selling their currencies.

2. Interest Rate disparity

The credit market is flooded with cheap credit such that the rate of risk-free interest is almost negligible. The Central Banks lose their relevance as they do not use temporary money supply in their calculations. The regulators arrive at a very high theoretical interest rate which is several times higher than the market-based interest rates. And because of this situation, they fail in effectively controlling liquidity through modification of interest rates.

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