Tomorrow's Affairs
Analysis of today
Assessment of tomorrow

By: Daniel Lacalle

Central banks are squeezing the private economy while shielding sovereign debt

Higher financing costs can weaken households and businesses without causing a financial crash. The danger is that policymakers mistake protected markets for a healthy economy.

Central banks can make life harder for households and productive businesses without imposing comparable discipline on governments.

That is the implication of a monetary framework that combines expensive private credit with extensive liquidity protection against financial-market disruption.

The absence of a crash should not be celebrated as proof that the policy mix is working.

In my view, a deep recession triggered by a systemic shortage of liquidity is not the central scenario.

The more plausible danger is a widening gap between resilient financial markets and an increasingly constrained productive economy.

Investors must understand that distinction, and policymakers should stop treating financial stability as a proof of economic strength.

The entire adjustment falls on the productive economy, which did not create the inflationary surge.

A small business facing higher refinancing costs cannot assume that a deterioration in its financing conditions will trigger a central-bank response. Sovereign debt markets, by contrast, remain the pillar of a financial architecture that authorities want to control at any cost.

Price of money v availability of liquidity

The conventional account of monetary tightening says that higher interest rates restrain credit and demand, eventually weakening activity and asset prices.

However, that account becomes incomplete when it ignores the distinction between the price of money and the availability of central-bank liquidity.

The Federal Reserve operates an ample-reserves framework, while the European Central Bank has a conditional instrument to counter disorderly fragmentation in sovereign financing conditions.

These arrangements help explain why financing can remain painful for private borrowers without producing an immediate breakdown in the financial system.

> Keeping the financial system liquid does not make the burden on households and productive companies any less real

Nor does a high nominal policy rate, by itself, establish how restrictive policy is. That assessment requires considering expected inflation, the equilibrium real interest rate, credit spreads and lending conditions.

Furthermore, bank reserves, broad money and the credit available to a small company are different things.

Treating them as interchangeable conceals the unequal transmission of monetary policy.

The criticism should therefore be precise. Maintaining ample reserves is compatible with restrictive interest rates.

However, keeping the financial system liquid does not make the burden on households and productive companies any less real, and it does not oblige governments to repair their finances.

Keeping the plumbing functioning

In his 22 September address, Roberto Perli, manager of the Federal Reserve's System Open Market Account, said money-market rates remained close to the interest rate paid on reserve balances, with overnight rates averaging slightly below it, suggesting reserves were in the upper part of the ample range.

This is a very different backdrop from a system experiencing an uncontrolled scramble for reserves.

The Fed had reduced reserve-management purchases to zero from mid-August because reserves were expected to remain ample, but Perli stressed that purchases were not on a preset path and could be adjusted again as conditions changed.

Pausing purchases therefore does not mean abandoning the capacity to supply reserves when needed.

The Fed also continues reinvesting principal payments from agency mortgage-backed securities into Treasury bills, even though those reinvestments do not themselves expand the portfolio.

Operational support for the system remains available without requiring a return to conventional quantitative easing.

> The central bank keeps the plumbing functioning, while governments mistake functioning plumbing for permission to keep borrowing

Reserve-management purchases are intended to maintain the reserves needed for monetary-policy implementation, rather than provide the kind of broad stimulus associated with QE. Calling every purchase "money printing" would weaken the argument. The relevant issue is that liquidity safeguards can coexist with expensive financing for the private economy.

Perli also noted that approximately $400 billion of cumulative net Treasury-bill issuance was absorbed around July and August with only modest upward pressure on repo rates.

That is evidence of resilience in short-term funding markets, rather than evidence that government borrowing has become harmless.

The danger is political complacency. If smooth debt issuance is interpreted as proof that deficits carry no consequences, successful liquidity management can become an excuse to postpone fiscal discipline.

The central bank keeps the plumbing functioning, while governments mistake functioning plumbing for permission to keep borrowing.

The unequal protection built into the system

The ECB's Transmission Protection Instrument allows secondary-market purchases to counter financing conditions judged unwarranted by national fundamentals and threatening monetary-policy transmission, subject to eligibility and sustainability assessments.

Its existence gives policymakers an additional defence against destabilising divergences in sovereign borrowing costs.

However, the TPI is neither an unconditional guarantee nor a permanently open liquidity tap, and its design explicitly seeks to avoid a lasting impact on the Eurosystem's overall balance sheet.

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It would therefore be wrong to claim that the ECB can, or will, prevent every sovereign or banking crisis.

Nevertheless, the political-economy problem remains. Authorities may seek to preserve monetary transmission while inadvertently

weakening the pressure for fiscal reform.

If governments come to expect intervention whenever spreads become uncomfortable, the line between preventing market dysfunction and protecting fiscal irresponsibility becomes dangerously blurred.

Households and smaller companies do not enjoy equivalent protection against the consequences of deteriorating cash flow.

Their adjustment comes through postponed investment, reduced hiring and curtailed consumption. The relevant criticism is the unequal protection built into the system, rather than an objection to preventing a financial panic.

Earnings explain why markets can remain resilient

Equities also have support beyond central-bank liquidity. Bloomberg shows projected S&P 500 earnings growth of 24% for the third quarter of 2026, with positive growth in 14 of its 16 sectors and double-digit growth in six.

That supports the view that earnings strength extends beyond a handful of companies.

FactSet's 18 September report showed that the S&P 500's forward 12-month earnings-per-share estimate had risen 8.8% since 30 June, compared with a 1.8% increase in the index itself.

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When expected earnings rise faster than prices, valuations can moderate without a market collapse.

Share repurchases provide another source of demand, with Neuberger Berman reporting $1.10 trillion in S&P 500 buybacks over the twelve months to June 2026.

Predicting an inevitable equity crash solely because borrowing costs remain elevated therefore ignores both corporate fundamentals and market demand.

However, forecasts can be revised, and strong listed-company earnings are not a comprehensive measure of household prosperity or small-business health.

A resilient index can coexist with substantial pressure elsewhere. Markets may be correctly pricing corporate cash flows while policymakers draw entirely the wrong conclusions about the wider economy.

A damaging model of economic management

The central risk is a policy mix that protects financial continuity while allowing the productive economy to absorb an excessive share of the adjustment. Liquidity facilities can reduce the probability of a funding accident. They cannot eliminate credit losses, repair an unsustainable fiscal trajectory or create the productivity needed to support rising public commitments.

Central banks should resist being turned into permanent insurers of governments' financing conditions - Daniel Lacalle

Nor should the answer be indiscriminate monetary easing. Cheap financing without fiscal restraint would risk extending the same

imbalance.

The necessary correction is to restore discipline where it has been repeatedly deferred, through credible spending control, sustainable commitments and reforms that enable private investment and competition to flourish.

Central banks should resist being turned into permanent insurers of governments' financing conditions.

Their success cannot be judged solely by whether sovereign auctions clear, bank funding remains orderly or equity indices avoid a correction. A system can remain liquid while the economy beneath it loses dynamism.

The absence of a recession is not a policy victory if it comes at the cost of a weaker productive base and growing dependence on government debt. Markets may stay resilient, supported by earnings and liquidity.

However, requiring households and businesses to absorb rate hikes while governments postpone any adjustment is a damaging model of economic management, and financial calm does not make it sustainable.