

JARGON ALERT

Liquidity Trap

BY RENEE HALTOM

Are there times when the central bank is powerless to stimulate short-term economic growth? Some economists say the economy is currently in such a situation, often called a “liquidity trap.”

The phrase has a nebulous definition in economics due to changes in the underlying theory since John Maynard Keynes first introduced the concept in the 1930s. The broadest definition is a situation in which monetary policy cannot stimulate the economy — the “trap” part — possibly because interest rates have already been pushed to zero. They have been at zero or close to it since December 2008.

A more precise definition of a liquidity trap is a situation in which people have a virtually endless demand to hold cash — an endless demand for liquidity — relative to other assets. In that situation, the central bank’s increases to the money supply fail to translate into increased consumption or investment to get the economy churning because the private sector simply holds on to the cash. The impotence of monetary policy in a liquidity trap is often asserted to justify alternative policies like fiscal stimulus. Yet it would be hard to determine in real time that the Fed’s expansionary efforts are having no effect on the economy given the myriad of competing influences — as a practical matter, it would be knowable only after the fact. Therefore, that definition may not offer much insight for real-time policymaking.

Many economists argue that liquidity traps can’t occur at all. Economic research suggests that central banks are far from powerless when interest rates hit zero. For example, quantitative easing has allowed the Fed to pump the banking system full of excess liquidity to push down lending rates. Additionally, the central bank can effectively ease lending conditions further by creating expectations that policy will remain stimulative, as the Fed has attempted to do since August 2011 by stating that it expected to keep interest rates very low for the foreseeable future. Financial markets appeared to respond positively when each of these policies were announced, suggesting that market participants don’t believe the Fed’s policies to be impotent.

In fact, there is, in principle, no limit to how much money the central bank could create; at an extreme, it could purchase every interest-bearing asset in the economy. Before reaching that point, people would likely start to bid up the prices of nonmoney assets, making investment more attractive and kickstarting economic activity.

What many economists seem to mean when they discuss a liquidity trap is a limit on the central bank’s *willingness* to stimulate the economy further rather than its *ability* to do so. That is, there are costs to monetary expansion, the most obvious being the risk of generating inflation.

Inflation has been contained since the Fed reached the zero bound, but policymakers might, nonetheless, judge that the economy will heal on its own with fewer costs than a recovery encouraged by additional monetary stimulus. For example, some economists, such as Philadelphia Fed President Charles Plosser, have argued that easier monetary policy could cause financial market distortions — making some investments artificially cheap relative to others — and the misallocation of resources down the road.

A central bank’s unwillingness to stimulate the economy further — given its assessment of the costs and benefits of doing so — may be more plausible than the conventional notion of a liquidity trap in which the central bank is literally powerless. Nonetheless, if policymakers judge that further monetary expansion would not be a net benefit to the economy, we may observe conditions that look and feel a lot like what might be expected in the technical defini-

tion of a liquidity trap — namely, persistently weak economic growth despite some strong measures by the central bank.

The evidence on liquidity traps, too, is murky. There are three commonly suspected episodes: First is the Great Depression, but economists Milton Friedman and Anna Schwartz famously noted that the Fed didn’t actually keep monetary policy easy in the mid-1930s. In fact, it inadvertently contracted the money supply due to an incomplete understanding of how a new reserve requirement policy would affect the financial system, making the Great Depression worse. Second is Japan’s “lost decade” of low economic growth in the 1990s (some economists even include much of the 2000s). Many economists, however, have argued that the Bank of Japan, too, became contractionary at points during that period, making it difficult to argue that it tried all it could to boost growth. Finally, some economists argue that we are in a liquidity trap following the 2008–2009 recession, given that we have not experienced a strong recovery despite the Fed’s unprecedented efforts to induce one. Though economic growth has been weak, many Fed policymakers have argued that the Fed is not — and never will be — out of ammunition, should conditions warrant it.

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