Liquidity trap

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The economic situation in a wide range of economies in the wake of the crisis that began

in 2007 is characterised by many as a liquidity trap. The original conceptualization of the

liquidity trap was part of Keynes's (1936) theory of liquidity preference. It referred to a

situation where the monetary authorities could not reduce the nominal long-term interest

rate any further by selling bonds because of the near universal expectation that interest

rates were so low that they could only rise and bond prices fall. "There is the possibility

[…] that, after the rate of interest has fallen to a certain level, liquidity-preference may

become virtually absolute in the sense that almost everyone prefers cash to holding a debt

which yields so low a rate of interest. In this event the monetary authority would have

lost effective control over the rate of interest" (Keynes, 1936, p. 207). In principle, the

liquidity trap could arise at any interest rate; the critical factor was that a conventional

expectation should have been formed that interest rates would not fall further. Given that

such a belief was formed under uncertainty, it was potentially volatile. But Keynes had

proceeded to explain that, while a liquidity trap had occurred under special

circumstances, it was in general unlikely.

Hicks's (1937) initial exposition of the IS-LM framework as a way of representing

Keynes's *General Theory* included the liquidity trap as a horizontal portion in the LM

curve at a low rate of interest. Modigliani (1944) later put a particular focus on the

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liquidity trap as capturing the essence of Keynes's monetary theory which, together with downward stickiness of wages, could account for an unemployment equilibrium as a special case. While the neoclassical synthesis perpetuated this version of Keynes as a special case, fundamentalist Keynesians protested that the IS-LM framework seriously misrepresented Keynes, not least for putting such an undue focus on the liquidity trap rather than the more general issue of liquidity preference under uncertainty.[1] Indeed Hicks (1980-81) himself concluded later that the IS-LM framework had misrepresented Keynes's analysis. The liquidity trap concept thus sank into oblivion.

But the liquidity trap term experienced a resurgence (most commonly associated with Krugman, 1998) when it became a reality in Japan, where monetary policy was unable to lift the economy out of recession. Nominal interest rates had gone to zero, implying that logically (rather than as a matter of expectation) they could really only rise.[2] Now, since the crisis that began in 2007, an additional range of economies (including the United States and much of the euro area) have also been classified as being in a liquidity trap (Krugman, 2013). Interest rates are at historic lows, making it difficult for monetary authorities to reduce long-term interest rates further.

But, as Kregel (2010) argues, the basis for the liquidity trap is being understood, by Krugman and others, not in Keynes's terms, but in loanable-funds/monetarist terms.[3] The concern therefore is that, in a deflationary situation, monetary authorities are unable to

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[1] See Davidson (1972) for a full account of Keynes's monetary theory (from a fundamentalist Keynesian perspective) in relation to the neoclassical synthesis.
[2] In fact in 1998 interest rates in the Japanese interbank market fell below zero.
[3] Kregel (2000) explains in further detail the relation between Keynes's theory, Hicks's interpretation and the Fisherian approach that underpins the Krugman-style modern use of the liquidity trap concept.

reduce the real rate of interest sufficiently for the market in loanable funds when nominal interest rates can fall no further. The only solution then is to engineer expectations of inflation through increases in the money supply. The problem is thus one of the zero lower bound rather than Keynes's liquidity trap, which could occur above that bound. For Keynes the trap was that liquidity would be hoarded until prospects of a real recovery emerged and that monetary policy was powerless to counteract this. Indeed, while the modelling account of the liquidity trap had put the focus on the choice between money and bonds, Keynes's exposition was set within the wider exploration of issues arising from recession explored in the *General Theory*, whereby liquidity preference effectively applied more widely than the money-bonds choice.[4]

It was not just that interest rates can only be expected to rise when they are very low. Keynes specifically expressed concern about "the ability of the monetary authority to establish *any given complex of rates of interest for debts of different terms and risks*" (Keynes, 1936, p. 207, emphasis added). In the aftermath of the banking crisis that began in 2007, while official rates of interest have been kept low, monetary authorities have been unable to control risk premia on such assets as the sovereign debt of some euro area countries and on bank loans to small companies, far less ensure availability. The problem is not just the confident expectations of speculative demand but also the lack of confidence in expectations (and thus in risk assessment) of precautionary demand, which account for the high level of liquidity preference and attitude to different types of debt. The outcome has been pools of liquidity in banks and large non-bank companies, which

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[4] See Dow and Dow (1989). This is explained further in Bibow's (2009) exposition of liquidity preference theory in the modern context.

are not being released to finance capital investment. The Keynesian solution to the liquidity trap therefore is fiscal policy designed to restore confidence in expectations of a recovery. How is this fiscal push to be financed? In noting the possibility of a liquidity trap, Keynes pointed out that "if such a situation were to arise, it would mean that the public authority itself could borrow through the banking system on an unlimited scale at a nominal rate of interest" (Keynes, 1936, p. 207).[5]

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[5] The term "nominal" is used to here to indicate a low level rather than to distinguish it from "real".

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