

# A Better Liquidity Trap

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Its puzzling why the Keynesian liquidity trap is so broadly used in the design of stabilization policy. The evidence shows that interest rates exert, relative to expectations of nonstationary profits, minor influence on business investment decisions. Moreover, even the minor effect disappears in circumstances of contracting aggregate demand. The critical problem here is economists' exaggerated faith in the liquidity trap crowds out attention to more robust determinants of total spending, especially investor/lender confidence which is also featured in *The General Theory*.

In the build-up to the acute instability of late 2008, there were two types of investor/lender confidence that, in retrospect, required management by central banks. The first is familiar: the trust that funds held by banks can be effectively withdrawn. That belief prevents bank runs and their damaging feedback on total spending and employment/output. Beginning in middle-2007, the ECB and the Fed, joined somewhat tepidly by the Bank of England, flooded the banking system with liquidity and aggressively used swap lines to channel dollars to Europe in the successful effort to keep the failures of three French funds managed by BNP Paribas, the British bank Northern Rock, and the US investment bank Bears Stearns from inducing bank runs. Walter Bagehot would have been proud.

A second manifestation of confidence would be less familiar to Bagehot but has been, since the spread of the Second Industrial Revolution, at least as important. In the 2008-09 extreme-instability macrodynamics, this confidence class dashed the hopes of stabilization authorities that plentiful liquidity by itself would effectively contain financial disruptions rooted in gathering uncertainty about U.S. residential-mortgage CDOs that had been distributed globally. Denoted by  $C$  in the GEM Project, it measures general investor/lender perceptions of the credibility of the real-side goals of stabilization policymakers. (Chapter 6) Perceived credibility is increasing in the degree to which future macroeconomic states can be characterized by probabilities rooted in the known objectives of monetary and fiscal authorities.  $C$  turns out to be a most consequential application of Lucas's admonition that expectations in macro modeling must take full account of observed government policies.

The bankruptcy of the investment bank Lehman Brothers in September 2008 produced immediate turmoil in the U.S., featuring disarray among stabilization policymakers (especially the ill-informed, unmindful Congress) and widespread dire assessments, most startling when coming from the respected chief of the Federal Reserve, of the significant possibility of repeating the devastating 1930s depression. Information on the macro future, most notably on the capacity of stabilization authorities to maintain sufficient aggregate demand to make good on their trend high-employment objectives, quickly deteriorated, increasingly seen as incomplete and asymmetric. Investors/lenders became uncertain. Nancy Stokey's insightful description of such circumstances demonstrates that gathering uncertainty breeds rational inaction. Many investors/lenders moved to the sidelines, waiting to see how the market turmoil gets resolved. An early casualty of buyer inaction was equity valuations. Sideline buyers provided an open field for short-sellers, and the S&P 500 fell by *half* in the six months after the Lehman debacle. It is foolish to argue that such a huge a drop resulted from a corresponding contraction in underlying productivity rooted in human and physical capital. We all know, at least deep down, that the stock-market collapse can only be understood as a collapse in confidence. (Chapter 6)

The GEM Project lays the groundwork for the necessary reconsideration of the Keynesian liquidity trap. Its familiar version occurs when a money-supply increase fails to reduce nominal interest rates, an increasingly likely outcome as rates near zero. Incremental money instead adds to idle balances, failing to stimulate nominal spending. That too-simple story is superseded by the Project's modeling of acute instability. The more powerful trap describes the failure of standard Fed open-market operations to stimulate greater spending in circumstances of uncertainty about stabilization authorities' real-side credibility. Once  $C$  has been damaged, interest rates no longer much matter. (Think it through. If interest rates were effectively allocating capital, they would not drop to zero.) In circumstances of extreme instability, interest rates are thoroughly dominated by uncertain expectations of trend profits, which are rooted in trend demand and ultimately stabilization authorities' real-side credibility.

The problems produced by the more robust liquidity trap cannot be solved by negative interest rates or other gimmicks such as the central bank announcing a temporary increase in their inflation target in the attempt to nudge the expected real interest rate lower or more aggressive forward guidance. I am always surprised at how eagerly responsible economists turn to gimmicks in periods of macro instability. The target idea was proposed

by Charles Evans, the President of the Chicago Fed; forceful guidance by Michael Woodford, who went on to assert that such guidance is more effective than quantitative easing. Both Evans and Woodford may have been driven to distraction by the failure of mainstream market-centric macroeconomics to come close to explaining what actually happened in 2008-09.

From the GEM perspective, the appropriate Federal Reserve response to the zero rates in the circumstances of acute instability is to accept the limitations of standard open-market operations and aggressively use its balance sheet in the effort to halt and reverse collapsing in total spending. There are a variety of strategies that can be used. (Chapter 10) However, given financial institutions' role in recycling saving into investment, an especially important stabilization focus must be frozen asset markets, inducing the Fed to become a buyer, lender, and guarantor of last resort in order to establish a credible floor for prices. Do not ignore the big claims of the GEM Project here. If investors/lenders had not persisted in their  $C$ -uncertainty, the Great Recession would have much different. It would have generated much diminished welfare loss, more in line with the modest instability cost associated with the internet-bust financial crisis in 2001. (Chapter 10)

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