

The Nonexistent Liquidity Trap

By Robert Genetski

Those who don't understand the monetary process often talk of a "liquidity trap." This refers to a situation where the monetary authorities pump money into the system, but it fails to produce an increase in spending. As interest rates come close to zero, some have talked of the Federal Reserve running out of bullets and therefore not being able to help boost spending. However, just as no one has seen the good fairy, no one has ever seen a liquidity trap.

Those who believe they have seen liquidity traps make the mistake of associating low interest rates with easy money. They point to periods of zero interest rates in the US during the early 1930s or to Japan's zero interest rates at the turn of the century and claim that the lack of spending represents a failure of additional money to stimulate spending.

Associating low interest rates with easy money represents a fundamental misunderstanding of the monetary process. Low interest rates can just as easily signal a restrictive monetary policy as an easy policy. For the US in the early 1930s, zero interest rates were consistent with an actual decrease in the money supply and falling prices. For Japan up until March of 2001, zero interest rates were consistent with a decrease in the growth in most measures of money. By mistaking low interest rates for easy money, central banks can inadvertently pursue restrictive monetary policies when they believe they are doing the opposite.

The reason there is no such thing as a liquidity trap is that the actions of the monetary authorities are comparable to those of counterfeiters. Central banks create money out of thin air. There is no effective limit on how much money they can create. Producing a small amount of new money tends to produce a small increase in spending. Producing a large amount of new money tends to produce a large increase in spending. When there is a major shock to economy (such as the failure of a major financial institution or a major terrorist attack), individuals naturally become hesitant to spend as aggressively as before the event. In this case, central banks may have to increase the amount of money they would normally produce to offset the effects of the shock.

In all of history there has never been a case where an aggressive increase in the money supply has not produced an aggressive increase in spending. Usually, the increase in spending occurs within 6-9 months of a more expansive monetary policy. However, in certain cases the increase in spending has occurred sooner or later. For the US economy, the longest lag between a shift to an easier monetary policy and an increase in spending has been thirteen months. The shortest has been two months.

Part of the problem with measuring the impact of money on spending is determining how to accurately measure a central bank's monetary policy. There are many different measures of money and these measures are not always either consistent or even accurate. In order to determine whether the monetary authorities are actually producing enough money to stimulate spending it's a good idea to look at a wide range of indicators.

To determine whether central bank has adopted an expansive monetary policy it's helpful to begin by looking at a range of money measures. These would include the monetary base (currency and bank reserves), M1 (currency, checking account deposits), M2 (M1 and time deposits). Although these particular money measures can be helpful, there are a variety of reasons why they can produce misleading signals from time to time. As a result, it's desirable to also look at market-based monetary indicators to confirm that monetary policy is actually expansive. An expansive monetary policy is generally associated with such developments as 1) an unusually wide gap between short and long-term interest rates, 2) rising prices for gold and

other commodities and 3) a weakening in a country's currency relative to those of other countries (if policy is expansive relative to that of other countries).

When various measures of money are expanding more rapidly and market-based indicators confirm the expansion, the central bank is producing enough money to boost spending. With respect to money, if the central banks produce it, we will spend it. You can take that to the bank.