

# AFTER THE GREAT FALL: I

*The 'liquidity trap', cited by Keynesian fiscalists for the impotence of monetary policy, is a paper tiger, says DEEPAK LAL*

It is now two years since the Great Crash of September-October 2008. The crisis has brought forth various dirigiste panaceas, along with a revival of crude Keynesianism. Some see the crisis as marking the collapse of market capitalism. My own diagnosis in my columns of early 2009 was consolidated in my "The Great Crash of 2008" (*Cato Journal*, 2010, 20(2): 265-277). But it is now time to see how events and policies have unfolded during the last two years and the lessons to be drawn. This is the purpose of this and the next few columns. In this, I discuss monetary policy and the claims of its impotence in the face of liquidity traps.

As I have argued, the 2008 Crash is best seen as a Hayekian recession caused by "easy money" with the Fisherian consequences of a "balance-sheet recession". How can the central bank avoid the deflationary Fisherian consequences of a financial crisis when — after the Hayekian boom — deleveraging is required by most agents in the economy?

It has been claimed (most stridently by Paul Krugman in his *New York Times* columns) that, once the central bank has cut interest rates close to zero, it would face a Keynesian liquidity trap, and the only recourse to keep up aggregate demand is through massive fiscal spending. Japan is cited as an example of a country in this trap. But is this argument correct?

Central to an answer is the transmission mechanism of monetary policy: whether it works principally through changes in interest rates or changes in broad money through the "real balance effect" which changes relative prices and net wealth. Meltzer (*A History of the Federal Reserve* Vol. 1, 2003) shows clearly, from charting the real interest rate against the growth of the real money balances in the US from 1919 to 1951, that "proposition 1: when growth of real balances rises sharply, expansion follows whatever happens to the real interest rate. Proposition 2: when real balances decline, or their growth is comparatively slow, the economy goes into recession even if the real interest rate is comparatively low or negative... Proposition 3: if the real interest rate is comparatively high, the economy expands if real balances rise and does not expand if they fall" (p 744). So, the transmission is from money to asset prices and in-



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flation or deflation via the real balance effect and not through interest rates. If broad money (M2/M4) expands, even with price deflation and hence rising real interest rates at the zero bound, the economy should expand.

To put Krugman's argument in perspective, it is important to distinguish between two types of liquidity traps, one, a "narrow" liquidity trap which applies to narrow money (M0 or M1), i.e. the monetary base, and a "broad" liquidity trap based on broad money (M2 or M4) which includes bank deposits. Tim Congdon ("Monetary policy at the zero bound", *World Economics* 2010, 11(1): 11-46) shows that the first one can occur if the central bank confines itself to money market operations with commercial banks to influence the monetary base. But the second will not, if it coordinates with the fiscal authorities to conduct debt market operations to change the broad money supply (including bank deposits). It is worth spelling out this difference.

In a money market operation, the central bank (say) purchases securities from commercial banks by expanding their cash reserves at the central bank, thereby expanding the monetary base (M0). Normally, the commercial banks would respond to their higher-than-desired cash reserves by expanding their liabilities, i.e. loans to the non-banking sector. The resulting increase in bank de-

posits would expand the broad money supply (M2/M4). However, in a banking crisis, the commercial banks may be unwilling to increase their liabilities (loans). In this case though the monetary base has increased, broad money will not. The economy is in a "narrow" liquidity trap.

But, if the central bank and the Treasury conduct a debt market operation in which (say) the Treasury sells new short-dated government bonds to the commercial banks for newly created public sector deposits at these banks, which it then uses to buy long-dated securities from the non-bank public, their bank deposits will increase, raising the broad money (M2/M4) supply. The government's temporary deposits at the commercial banks are replaced by the long-dated securities it purchases from non-banks, which can then be extinguished. The net effect being unchanged total government debt, of shortened maturity, and an increased broad money supply. An alternative would be that the central bank itself purchases assets from non-banks, thereby increasing their bank deposits and thus broad money. This is the form that the loosening of broad money through "quantitative easing" (QE) has, in fact, taken after the crisis. It is only if the increase in broad money has no effect on the non-banks' normal desire to substitute excess cash for bonds or equities (or general spending) — i.e. the non-banks' demand to hold money is infinitely

elastic — that there will be a "broad" liquidity trap. There is no evidence that this has, in fact, occurred.

Congdon (op.cit.), in examining the long Japanese deflationary episode, shows that it was due to inappropriate concentration on the "narrow" money definition of money and its control by the central bank through money market operations with the commercial banks. If it had coordinated with the finance ministry to expand broad money by debt market operations, it could have engineered an economic expansion even if there was price deflation and a near-zero interest rate.

Ben Bernanke had clearly learnt this lesson when he argued that the monetary authorities could always increase the broad money supply at a zero interest rate through unconventional means, for which he was nicknamed Helicopter Ben. During the recent crisis, through QE, the second leg of a Fisherian debt deflation has been prevented by the Fed, as well as the Bank of England and the European Central Bank.

The current concern is the ability of these central banks to exit from QE in time, before the inflationary consequences of their exploding balance sheets lead to inflation, and rising nominal interest rates on government debt, worsening the debt dynamics of the public sector. But by and large, the "liquidity trap", cited by Keynesian fiscalists for the impotence of monetary policy, is a paper tiger.