

# **A Liquidity Trap?**

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No country has ever been in a liquidity trap, and Japan is not in one now. Statements to the contrary are based on faulty analysis.

A liquidity trap means that increases in money by the central bank (monetary base) cannot affect output, prices, interest rates or other variables. Changes in the money stock are entirely matched by changes in the demand to hold money.

The idea of a liquidity trap originated with Keynes during the Great Depression. Keynes conjectured that once the interest rate fell below 2%, monetary expansion might not work. It would "push on a string". Even he recognized that a liquidity trap had never occurred.

In fact, monetary policy was powerful during the Great Depression. Deflationary monetary policy was the major cause of the economic collapse from 1929 to 1933. Once President Franklin Roosevelt abandoned the gold standard and devalued the dollar, gold poured in, the monetary base and money rose. Output expanded rapidly; real GNP rose at more than 10% average annual rate in the next three years.

The fact that a short-term rate in Japan is near zero tells us more about mistaken monetary policy has done than what proper monetary policy can do. Prices are not stable, they are falling. Interest rates are not constant, they are falling. The Bank of Japan could stop the interest rate and price decline by purchasing foreign exchange, corporate bonds, or other assets. Such purchases would increase money growth, end deflation, and promote recovery.

Monetary policy works by changing relative prices. There are many, many such prices. Some economists erroneously believe there is a liquidity trap because they think monetary policy works only by changing a single short-term interest rate. If the Bank of Japan follows through on its recent commitment to increase money growth, this way of thinking will be falsified, as it was during the Great Depression and on many other occasions.