The Keynesian Liquidity Trap Fable

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Commentary

Many economists wrongly assume economic activity is accurately presented as a circular flow of money. Spending by one individual becomes part of the earnings of another individual; spending by another individual becomes part of the first individual's earnings. Assuming this, recessions are because individuals—for whatever psychological reasons—have decided to cut down on their expenditure and raise their savings.

For instance, if some individuals have become less confident about the future, they are likely to lower their outlays and "hoard" (save) more money. Therefore, once individuals spend less, this will necessarily worsen the situation of some other individual, who, in turn, also cuts his spending. A vicious cycle, therefore, sets in—the decline in an individual's confidence causes him to spend less and to "hoard" more money; this lowers economic activity further, thereby causing individuals to "hoard" more, etc.

Following these faulty assumptions, in order to prevent a recession from getting out of hand, the central bank must expand the money supply and aggressively lower interest rates. Once individuals have more money in their pockets, it is believed, their confidence will increase and they will start spending again, thereby reestablishing the "circular flow" of money.

On the other hand, a situation could emerge when aggressive lowering of interest rates by the central bank could bring rates that could not decline further. As a result, the central bank will not be able to revive the economy. This situation is labeled as a "liquidity trap." Allegedly, the liquidity trap could occur because individuals might adopt a view that the interest rates have bottomed out and that the interest rates should subsequently rise, leading to capital losses on bond holdings. As a result, individuals' demand for money would become extremely high, implying that individuals would "hoard" money and refuse to spend it no matter how much the central bank tries to expand the money supply.

Most experts are of the view that once a low-interest-rate policy becomes ineffective, monetary authorities should step in and spend. The spending can be on any and all sorts of projects. What matters here is that a lot of money must be pumped through inflation of money and credit. This is expected to boost consumer confidence. With the hoped-for higher level of confidence, consumers are likely to lower their savings and raise their expenditure, thereby reestablishing the “circular flow” of money.

Does the ‘Liquidity’ Trap Emerge Because of the Lack of Consumer Spending?

According to some popular thinking, the ever-expanding monetary flow is key for economic prosperity—what drives economic growth is spending. When individuals spend more of their money, this implies they save less. Conversely, when individuals reduce their monetary spending, they save more. Saving is supposed to be bad news for the economy—the more individuals save, the worse things become. The “liquidity trap” comes from too much saving and the lack of spending, according to this theory.

Observe, however, that individuals do not ultimately pay with money, but rather with goods that they have produced. The chief role of money is to fulfill the role of the medium of exchange. Hence, the demand for goods is constrained by the production of goods and not by the amount of money as such. (The role of money is to facilitate the exchange of goods).

To suggest that people could have an almost-unlimited demand for money—leading to unlimited savings and a “liquidity trap”—would imply that no one would be exchanging goods. Obviously, this is not a realistic proposition, especially given the fact that individuals require goods to support their continued existence.

Being the medium of exchange, money can only assist in exchanging the goods of one producer for the goods of another producer. The medium-of-exchange service that money provides has nothing to do with the production of consumer goods as such. What permits the increase of these goods is production, saving, and accumulation of capital goods. With more capital goods (i.e., tools and machinery), individuals' ability to produce goods of greater quantity and quality more efficiently increases.

A so-called "liquidity trap" does not emerge in response to consumers' large increases in the demand for money, but comes as a result of expansionary monetary policies, which inflict damage and distort production, savings, and the capital structure.

The 'Liquidity Trap' and the Shrinking of Savings

As long as the growth rate of savings stays positive, this can continue to sustain productive and consumptive activities. Trouble erupts when, because of expansionary monetary policies, a structure of production emerges that ties up much more producer and consumer goods than the amount it creates and maintains. Excessive consumption relative to the production of capital and consumer goods leads to a decline in savings and capital. This, in turn, weakens the support for individuals that are employed in the various stages of the production structure, resulting in the economy plunging into a slump.

Once the economy falls into a recession because of a declining savings and capital investment, any central bank attempts to revive the economy through further inflation will fail. Not only will these attempts fail to revive the economy, these attempts are going to deplete savings and distort the capital structure further, thereby prolonging the economic slump.

The shrinking genuine savings and capital investment exposes the erroneous nature of the commonly-accepted view that expansionary monetary policies can grow an economy. The fact that central bank policies become ineffective in reviving the economy is not due to the "liquidity trap." Rather, this decline emerges due to previous expansionary monetary policies.

The ineffectiveness of inflationary monetary policy to generate the illusion that the central banks can grow the economy has nothing to do with the “liquidity trap.” The ineffectiveness is always present whenever the central authorities are attempting to “grow the economy.” The only reason why it appears that these policies “work” is because savings are still expanding during that period.

Monetary Liquidity and the Stock Market

When money supply increases, it enters various markets, including the stock market. Whenever new money enters a particular market, it means that now we have a greater amount of money per unit of goods in that market. A price of a good is the amount of money per good or per asset. Hence, all other things being equal, an increase in money supply results in an increase in the prices of goods. For a given amount of money, the value of stocks is going to be determined by the real wealth produced and expected by various activities that stocks represent. With the expansion and the enhancement of the infrastructure (i.e., capital goods) more wealth and hence a greater economic growth emerges.

When the central bank tampers with money supply, however, this misleads investors. They perceive the increase in money as the increase in wealth. This, in turn, causes them to push the stock market prices higher.

As long as savings are still expanding, the central bank’s expansionary monetary policies are driving the stock market higher. Once savings start to decline and/or the central bank contracts monetary policy, the stock market follows suit. In this sense, the attempt by the central bank to counter the “liquidity trap” prolongs the economic slump and the bear market in stocks.

Conclusion

Contrary to much popular thinking, if the U.S. economy were to fall into a so-called “liquidity trap,” the reason for this is not a strong increase in the demand for money, but because previous expansionary monetary policies have depleted savings and distorted the structure of production.

From Mises.org

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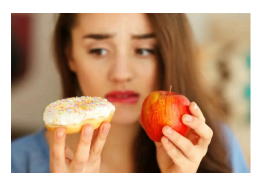

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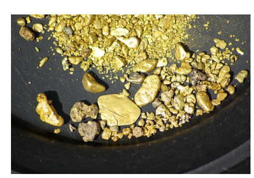

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