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The global liquidity trap

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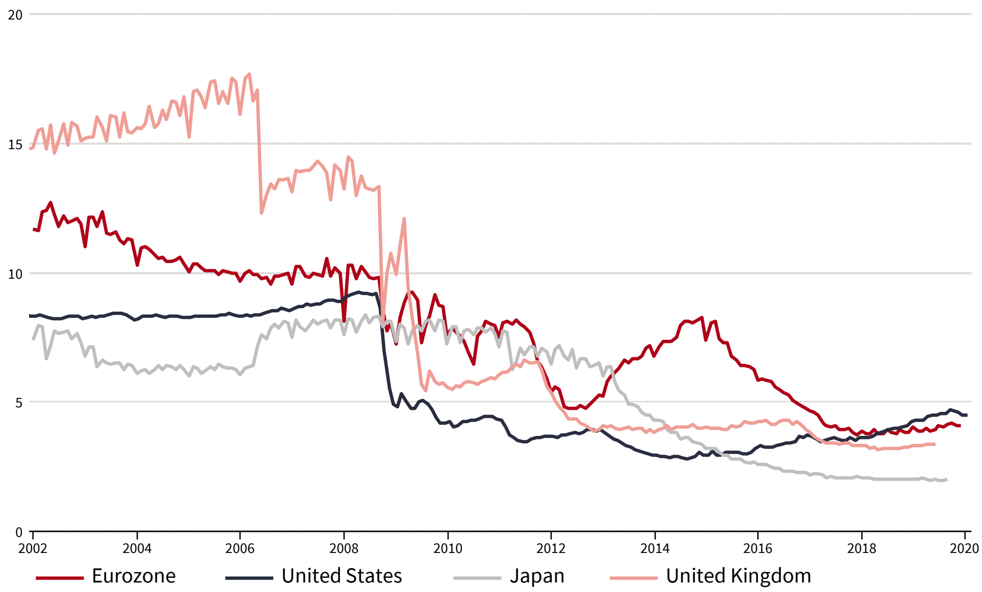
For Mark Carney, governor of the Bank of England, the global economy is heading towards a "liquidity trap". Developed by Keynes in the 1930s, the concept of a liquidity trap refers to a situation in which conventional monetary policy becomes ineffective at stimulating the economy because short-term interest rates are at or approaching zero. When target interest rates are pushed into negative territory, fiscal policy must become the first line of defence against an economic slowdown.

A few weeks from the end of his mandate, **Mark Carney, governor of the Bank of England (BoE), issued a warning** in an interview with the Financial Times published on 7 January[1]: **the global economy is heading towards a "liquidity trap".** Due to low rates, warns Mark Carney, the main central banks risk running out of the ammunition needed to combat a major financial crisis.

Developed in the 1930s by John Maynard Keynes, the concept of a liquidity trap refers to a situation in which **conventional monetary policy becomes ineffective at stimulating the economy because short-term interest rates are at or approaching zero**.

The monetary multiplier has ceased to account for monetary creation

Ratio : Money supply (M2 or M3) / Monetary base (M0)



In a liquidity trap, economic agents no longer see a difference between holding bonds that yield zero or near-zero rates and holding money, and their **demand for liquidity becomes virtually infinite**. In this context, an expansionist monetary policy increases the offer of currency / liquidity in the economy, but **the currency created by central banks is largely hoarded**

[1] See Financial Times (2020), "Central banks running low on ways to fight recession, warns Mark Carney", 7 January.

instead of being invested in the real economy. Banks prefer to accumulate excess reserves at central banks rather than grant loans, and companies and households prefer to hoard money rather than invest and consume.

An economy typically falls into a liquidity trap following a shock (sudden loss of wealth due to a collapse of asset markets, massive deleveraging process, etc.) strong enough to cause a sharp increase in the desire for savings and/or a decline in the desired level of investment. This causes the "equilibrium" or "natural" rate of interest [2] – the theoretical rate that ensures the savings-investment balance at full employment of resources – to fall to a very low or even negative level.

Until the 2008 financial crisis, the liquidity trap remained a rare phenomenon; the United States during the Great Depression of the 1930s and Japan following the collapse of the stock and real estate markets at the start of the 1990s are two rare and remarkable examples.

But since the 2008 crisis, we have seen a significant portion of the developed world become caught in the liquidity trap. As in the crash of 1929 in the United States and the Japanese real estate bubble burst in 1991, the collapse of financial and real estate asset prices in 2007-2009 led to a considerable loss of wealth, first in the USA, then in the rest of the world. Having become a priority for the private sector, balance sheet repair gave rise to a cycle of deleveraging, notably in the United States, and significant segments of the global economy cut their investments and saved on a massive scale. The result: a global excess of savings, which led the natural interest rate to plummet into exceptionally low or even negative territory.

To contain financial instability and attempt to revive their economies, the large central banks have, since 2008, injected huge amounts of liquidity into the economy and reduced their key rates to zero or near-zero. But **even with the (nominal) rates of central banks reduced to zero, effective real interest rates** (inflation deducted) **still remain too high** to ensure the rebalancing of savings and investment at the full employment of resources.

The problem is that central banks cannot cut key rates further below zero, since the public, rather than lending at a negative nominal rate, prefers to hold money at zero rate of return. The liquidity trap is also referred to as the "zero lower bound on nominal interest rates" problem.

Since interest rates cannot fall further, the liquidity injected by central banks has no effect on the real economy: **aggregate demand, economic growth, and inflation are "trapped" at low levels**.

For some, there is no need to be overly concerned about the liquidity trap, since central banks have access to other instruments, such as the policy of forward guidance and quantitative easing policies that aim to influence long-term rates. For others, such as Mark Carney, the liquidity trap represents a serious threat for developed countries; they hold that once the zero-lower bound on nominal interest rates has become binding, **fiscal policy must be the first line of defence against an economic slowdown**. This is not only because monetary policy becomes ineffective at stimulating the economy, but also because very low interest rates are generally associated with excessive risk-taking and an increase in the frequency of speculative bubbles.

2 See Societe Generale (2019), "The long-term equilibrium rate of interest", Economy for all, July.

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