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Monetary policy in deflation: the liquidity trap in history and practice

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Abstract

The experience of the U.S. economy during the mid-1930s, when short-term nominal interest rates were continuously close to zero, is sometimes taken as evidence that monetary policy was ineffective and the economy was in a "liquidity trap." Close examination of the historical policy record for the period indicates that the evidence does not support such assertions. The incomplete and erratic recovery from the Great Depression can be traced to a failure to pursue consistently expansionary policy resulting from an incorrect understanding of monetary policy in an environment of very low short-term nominal interest rates. Commonalities with the Japanese experience during the late 1990s, and the inadequacy of short-term interest rates as indicators of the stance of monetary policy are discussed and a robust operating procedure for implementing monetary policy in a low-interest-rate environment by adjusting the maturity of targeted interest-rate instruments is described.
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1. Introduction

Writing in 1930, a few months into the "slump" we now know as the Great Depression, John Maynard Keynes expressed concern that the monetary policy necessary to restore prosperity might not be forthcoming. "I repeat that the greatest evil of the moment and the greatest danger to economic progress in the near future are to be found in the unwillingness of the central banks of the world to allow the market-rate of interest to fall fast enough" (1930, p. 207). Anticipating a subsequent debate, Keynes provided a careful analysis of possible practical limits to expansionary monetary policy in a slump—what would later

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be called a “liquidity trap.” He dismissed the notion that monetary policy would become ineffective during a slump—provided policymakers were willing to take deliberate and vigorous action towards restoring prosperity. “Yet who can reasonably doubt the ultimate outcome [a lasting recovery]—unless the obstinate maintenance of misguided monetary policies is going to continue to sap the foundations of capitalist society?” (p. 384). Even without any real constraints on the ability of a central bank to take expansionary action, however, Keynes recognized that “the mentality and ideas” of the policymakers themselves could stand in the way of the necessary policies. His words revealed less than full confidence that the appropriate policies would be pursued. “It has been my role for the last 11 years to play the part of Cassandra ... I hope that it may not be so on this occasion” (p. 385). Subsequent events, unfortunately, proved that Keynes was still a captive of Apollo’s wicked curse.

In the United States, Federal Reserve policy during the 1930s is widely recognized as a dramatic failure. But it took many decades for Federal Reserve officials to accept responsibility for that failure, and, more generally, it took considerable debate over a long period of time for economists and historians to reach substantial agreement on the harm that monetary policy caused during the 1930s. While some (including Keynes himself) had little doubt regarding the unhelpful role of monetary policy, others (including, many “Keynesians”) concentrated instead on other factors, including the role of fiscal policy, especially after Keynes (1936) highlighted its potential for fighting the slump.[1] The tale of the “ineffectiveness” of monetary policy to inflate the economy from a slump provided a convenient alternative explanation of events that also afforded a much less negative view of the role of monetary policy during that episode.

With inflation becoming the norm in the industrialized world following World War II, monetary policy in a deflationary environment largely remained the subject of historical inquiries. But the liquidity-trap debate re-emerged in relation to developments during the 1990s in Japan, and more recently and largely based on concerns stemming from the Japanese experience, in relation to the possibility of deflation in other industrialized economies. Importantly, while the Japanese economy of the 1990s has not been through a catastrophe of a magnitude similar to that experienced in the U.S. of the 1930s, some uncomfortable similarities, especially regarding the possible role of monetary policy action or inaction, have not escaped attention.[2]

In this paper I revisit some of the relevant historical experience associated with the liquidity-trap debate, to reexamine one aspect of the specific question suggested by Keynes in 1930: is the liquidity trap an inescapable reality of modern capitalist economies, or is its appearance merely an artifact of “misguided monetary policies” reflecting the “unwillingness” to adopt adequate monetary policy action? The question is important, for it points

[1] See Leijonhufvud (1968) for a discussion of this and other differences between the economics of Keynes and what later became associated with Keynesian economics. See Friedman and Schwartz (1963) and Temin (1976) for the classic monetarist and Keynesian interpretations of the Great Depression, respectively.

[2] The role of monetary policy in Japan and comparisons with the U.S. experience during the Great Depression have been the subject of numerous studies in recent years, including Ahearne, Gagnon, Haltmaier, and Kamin (2002), Bernanke (2000), Coenen and Wieland (2003), Kuttner and Posen (2001), Krugman (1998, 2000), McCallum (2000), Meltzer (1999), Okina (1999), Orphanides and Wieland (1998, 2000), Reifschneider and Williams (2000), and Svensson (2001).

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