

“A Symposium of Views: Is the World Flirting with a Global Liquidity Trap?”

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The classic “liquidity trap” is an intellectual creation, not an observable phenomenon. There is not now and in my opinion never has been an actual episode satisfying the requirements of the so-called “liquidity trap.” Keynes himself regarded what has come to be called a liquidity trap as a strictly “limiting case” of which, though it “might become practically important in the future,” he knew “of no example...hitherto.”

The problem from 1929 to 1933 in the United States was not a liquidity trap. It was a situation in which the central bank permitted the quantity of money to decline by a third. Neither is the situation in Japan today a liquidity trap. It was a situation in which the Bank of Japan has been holding money growth at a low level at the same time the country is in a deflation; hence low nominal interest rates are high real interest rates. In both instances, the central banks had/has the power to increase the money supply to any extent desired. Had the Federal Reserve kept the money stock rising after 1929, I do not believe there would have been a Great Depression. Had the Bank of Japan done that over the past five or six years, I do not believe that Japan would be facing a severe recession today. Monetary policy is no less powerful today than it has been over history. Thanks to the inflationary surge of the 1970s, monetary policy has had to be relatively restrictive in order to bring inflation down to its present low levels. There will be case after case in which monetary policy can temporarily be much more expansive, but that is a far cry from a liquidity trap or the threat of a “potentially less powerful” monetary policy tool.

While as powerful as ever, monetary policy is not a panacea. It is not an all powerful instrument. It can prevent and produce major inflations and major deflations. It cannot effectively fine-tune the economy.

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