

Thought for the Week: Monday, March 21st, 2011

Is the U.S. Stuck in a Liquidity Trap?

What's a Liquidity Trap?

A situation where **all attempts to stimulate an economy fail** is normally described as a Liquidity Trap. Traditionally, **stimulus involves lowering interest rates and increasing money supply**.

Basically, a Liquidity Trap is where a government pumps money into an economy but the **people/organizations with spendable assets resist the temptation to spend/invest** those assets. If the news is full of adverse events, civil unrest, natural disasters or predictions of falling demand, it's easy to keep your money in your pocket.

A more technical explanation would define a Liquidity Trap as a period where **continued injections of liquidity into the economy have no effect on demand or interest rates**, a.k.a. Infinite Elasticity of Money Supply.

OK, we are not here for Economics 101, so let's move on to the important stuff...

Why is a Liquidity Trap Important?

If we are in a Liquidity Trap, the current U.S. macro-economic policy of Quantitative Easing (**Q.E.**) **will have no further effect on real economic growth**. We can continue to increase the national debt and deficit for no reason.

Think of money supply as a rubber band.

As the band (money supply) is expanded by pulling on the right hand side, demand (the left hand side) should also move at some stage. However, it remains stubbornly stationary, no matter how far money supply expands.



We call this **Infinite Elasticity** – the government can expand the rubber band by printing more and more money, thereby increasing its supply, with little or no net effect on the economy.

A second metaphor is **Q.E. is like “pushing on a string”** – push as hard as you like on one end, the other end barely moves.

Moreover, by “Easing” vast “Quantities” of money into our economy, the Federal Reserve thought banks would finance more loans at “too good to resist” interest rates. This would help the housing market to recover and stimulate investment, consumer and capital spending.

Instead, the **banks invested the money themselves**, often by lending it back to the government.

Japan – for a second week running...

Although some economists dismissed the Liquidity Trap concept in the 1960's, since the 1990's the predicament of the Japanese economy has shown the effect described above does exist. For many years, **Japanese interest rates have been 'virtually' zero**; however, borrowing and the economy have stagnated. If you are offering "virtually free money", how come there are so few takers?

Traditional economics teaches us that cheap capital can generate asset bubbles. Clearly there are exceptions to this rule! The Japanese have had access to cheap capital for years and their Gross Domestic Product shows no signs of bubbling up.

It is now generally agreed that **expansionary monetary policy affects the economy by lowering interest rates; it cannot stimulate an economy** when the economy is in a liquidity trap.

Conclusions for the U.S. Economy

America is not Japan, there are many differences which we feel will ensure our economy does not suffer from a prolonged, liquidity induced, stagnation.

One of the main differences is the person who controls our economy is Ben "The Ben" Bernanke, an expert on Japan following the bursting of its 1980's housing bubble. In 2000, Bernanke actually wrote an article titled "Japanese Monetary Policy: A Case of Self-Induced Paralysis".

Ben has previously suggested that if a central bank "helicopter drops" enough money to the masses, then **at some point it will cause prices to rise**. Even if prices fail to inflate, the central bank will still have succeeded in creating real wealth with printed money. It's a potential win-win situation.

However, if the Infinite Elasticity theory holds, the rubber band will stretch without an expansion in demand until the rubber band breaks.

We feel the band will not break and "helicopter" Ben, in concert with more expansionary U.S. business and consumer environments, will succeed in creating demand. That said, the U.S. dollar may be the main casualty.

One final, positive thought; if the Federal Reserve ends Quantitative Easing in June of this year, it may have little negative effect on economic demand, outside of a reaction from stock markets.

Conclusions for DIAS Management

If demand remains subdued, despite hikes in many input goods and commodities, **companies without pricing power** (the ability to raise prices to account for increased costs) will have a hard time maintaining earnings levels. **Those with pricing power should fare much better**.

Investors may consider a greater focus on **investments which generate income and seek to protect capital**. Conservative Income and Conservative Income with Growth should continue to pay investors **attractive income levels while actively avoiding, or reacting to, any threats to long-term capital stability**.

