Escaping the Liquidity Trap

The world economy is collapsing at frightening speed. Sales and orders are drying up, not because people's wants have been satisfied - they are as large as ever - but because many people's ability to find the money to pay for their wants is shrinking. The root of the problem is that money is being returned to the banks to repay past loans faster than new money is being injected into the global economy by fresh loans being taken out.

Governments have injected billions into their banking systems in the hope that the banks will stop the money supply contracting by lending more but, in the US and Europe at least, the strategy has failed. The rate at which loans are being taken out for everyday purposes such as property purchase and industrial investment is still falling.

This is entirely understandable. In present circumstances, why would the banks lend to the public and why would the public borrow? The fall in demand has left excess capacity in every major sector of the global economy and prices are falling. In the light of this, what projects can be found that would give borrowers a return sufficiently high to compensate them for running the risk necessarily involved in pledging their assets to secure a loan? They could lose their assets and make themselves substantially worse off. And, since their assets are falling in value anyway, would their banks accept them as adequate collateral to safeguard them against losing money themselves? The only people wanting loans these days are likely to be those whose businesses are in such deep trouble that the banks would not want to lend to them anyway,

This situation is called a liquidity trap. No matter how low the base interest rate goes – and in Britain and the US they are approaching zero - almost no-one is prepare to lend or to borrow. As a result, the amount of money in circulation is continuing to contract, cutting demand and making it progressively difficult for existing borrowers to assemble the money they need to service their loans. Whenever they fail, the banks' bad debts increase and the governments responsible for them feel compelled to come to the rescue by borrowing money themselves and handing it over to make good the losses.

Unfortunately, these government injections do nothing to improve the situation. They merely stop things getting worse by preventing the banks collapsing or having to call loans in prematurely to maintain their capital adequacy ratio. (Calling in loans would be very damaging as it would force customers to try to raise money quickly by selling off property in a market in which no-one could borrow the funds to buy it.)

For the government money to do any good it has to find its way into the accounts, or pockets, of people and firms who would spend it. However, it's surprisingly hard to put it there while maintaining conventional ideas on what constitutes financial discipline. For example, now that it has become clear that ultra-low interest rates are not solving the problem, the US government is trying to get more money into circulation by “quantitative easing”. This involves it buying up government bonds and other securities from individuals and pension funds at attractive prices.

This puts money into the vendors' bank accounts but it does not mean that the accountholders will spend it. If the assets they sold were being held for savings purposes, it's very likely they will continue to save the government payments they receive and will lodge them in a short-term interest-bearing bank accounts until they can think of something better. The banks themselves will be happy to get the money, even though they will not lend much of it out, because it improves the ratio between their customers' deposits and the amount they have in outstanding loans. (It was Northern Rock's poor deposits-to-loans ratio that made it very reliant on the wholesale money markets and, when these refused to lend, led to its nationalisation. Banks with better ratios have less need to borrow internationally and are therefore perceived as being safer. This means that they get a better rate when borrowing wholesale. It also improves the price of their shares.)

So quantitative easing is unlikely to work unless the new money is used to buy bonds issued by manufacturing companies which plan to invest. Such companies are currently thin on the ground.

There are only two other conventional ways that government money can get to where it's needed. One is for the government to spend it into use. It could, for example, place contracts for infrastructural development. The second way is for the state just to give the money away, perhaps by making extra payments for a limited time to groups such as pensioners and social welfare recipients who would be fairly sure to spend it quite quickly.

The problem with either way is that, if the government proceeded along orthodox lines, it would incur a massive deficit and have to borrow the funds. No government likes doing that because it increases the national debt and means that a higher proportion of its tax income has to be used for servicing its loans, thus restricting its freedom of action for years into future.

A government has therefore to be prepared to adopt unconventional techniques if it wishes to avoid borrowing the money it needs to spend to keep the economy from collapse. One such technique is to create the money using exactly the same method that the Americans are adopted for quantitative easing. The US money is being issued without debt since it would make absolutely no sense for the government simply to borrow the funds to buy its own securities within the country as, if it did, the whole exercise would have no effect on the amount of money in circulation nationally.

Governments other than that of the US are currently reluctant to use this technique. Although Britain has been borrowing money in order to try to stimulate demand by cutting taxes, the Chancellor of the Exchequer, Alistair Darling, has said that nothing on the lines of quantitative easing is planned. "Nobody is talking about printing money," the BBC[i] reported him as saying on January 8th.

The European Central Bank is also unlikely to inject debt-free money into the economies for which it is responsible until things get much worse. This is because all sixteen countries that use the currency would have to approve the scrapping of the ECB's statute which prohibits it from funding governments by purchasing their bonds. At the moment, it can only buy already-issued bonds from those holding them. The governments would also have to agree how much new money was to be created and how it was to be divided up amongst them. This is likely to be contentious as, naturally, they would all like to be given "free" money.

The main reason for the European reluctance is that the technique has been badly misused almost every time it has been tried. This is because, once a government can use the method, it is very much easier for it to create money that way than it is to raise it through taxation. Taxes are politically unpopular. Issuing debt-free money isn't, at least at first. So governments become lazy and spend too much of their new money around, creating an inflation that erodes their people's savings. Some inflations caused by government-created money have been dramatic, like the 5,000% a year rate in Argentina in the late 1980s or the 231,000,000% produced by Robert Mugabe in Zimbabwe in July 2008[ii].

Accordingly, the conventional wisdom is that if governments were to take over at least part of the money creation function from the commercial banks, which is what this technique involves, inflation fears would reduce the value of the currencies concerned in comparison with those created in a conventional way.

Two things can be said about this. One is that, for the immediate future, deflation is a much more serious risk than inflation. Most governments would breathe a sigh of relief if demand became strong enough to start pushing prices up at 3% a year again. Professor Willem Buiter of the LSE, a former member of the Bank of England Monetary Policy Committee, regards refusing to create non-debt money on the basis that it might be inflationary as equivalent to refusing to drink water because one might be drowned[iii]. The second point is that there is no essential or legal or political requirement for politicians to be in charge of governmental money creation. Just as the Bank of England's monetary policy committee was given sole responsibility for setting the interest rate, a truly independent body working to a clear and legally-enforceable brief could be set up to control the issue of non-debt money.

It is important to recognise that debt-based and non-debt-based monies are very different animals and have different roles to play. Non-debt money is intended purely as a medium of exchange. It is being created out of nothing in the US purely to get trading going again. It is not intended as a store of value, a currency in which people keep their savings. If debt-based and non-debt-based currencies are given different names and kept apart – something the US is not doing – then the public's concerns about inflation should be minimised.

There is no legal or political reason to have only one type of money in circulation at a time. Having one currency for trading and another for saving would enable the economy to adjust more readily to changing circumstances. For example, if energy prices rose considerably in future, the prices of goods would have to change to reflect the cost of the energy involved in their production. These changes would be by different amounts, and the only way that the different rises could be accommodated easily is in an inflationary environment. A trading currency that was not relied on to keep its value because no-one saved in it and which could be issued in a controlled amount to allow a planned inflation would allow the adjustment to proceed quickly and smoothly.

Non-debt money has another massive advantage over the debt-based kind - it does not disappear from circulation when loans are repaid. Nor does it require people to continue to get into debt for the economy to remain healthy. This characteristic is likely to be very important in future since people are bound to be reluctant to borrow on scale required to keep an adequate amount of trading going on if the economy begins to shrink as the use of fossil energy declines, whether the decline in energy use is as a result of actions to limit climate change or because of resource depletion. Debt-based money worked tolerably well in an expanding world. It is totally unsuited to providing the means of exchange in an economically-contracting one.

So Feasta believes that the new method of money creation required by the liquidity crisis is one that is needed anyway to cope with the peak in global oil production and climate change. However, even if one rejects this view and believes that the world economy will recover and resume its path of expansion, the temporary use of non-debt money can be seen as a pragmatic response to a temporary emergency. Willem Buiter certainly sees the use of non-debt money in this light and talks of its being withdrawn from circulation when the crisis has passed. Whoever is right, once the liquidity emergency is over, the situation can be reassessed in the light of experience. The non-debt money can either be withdrawn or, if it seems that it would be useful on a continuing basis, adopted as a permanent monetary policy tool. If that happened, an arms-length body should be set up to run the currency and the rules governing its creation and distribution established.

The conclusions for Ireland

It looks as though the number of euros in circulation in Ireland will continue to contract because the government is unwilling – and possibly unable – to borrow enough itself to make up for the fall-off in private-sector borrowing. If that's correct, the growing shortage of money will lead to widespread hardship and increase the difficulty that firms and families experience in paying their taxes and servicing their loans. The banks' bad debts will grow and the government, unable to meet its guarantees and its other spending obligations, will be forced to default. This outcome seems unavoidable unless some form of non-debt money is introduced to replace the missing euros and free up the remaining ones for meeting debts and external obligations. Such a currency could be issued like this:

1. A new unit, the quid, would be announced as an emergency currency to be used exclusively for trading purposes. It would not have any fixed exchange rate with the euro although, at least initially, the intention would be to keep it scarce enough for people to change it on a one-for-one basis.
2. The commercial banks would be instructed to open quid accounts for each of their customers. Individuals with current accounts in more than one bank would be asked to nominate the bank at which they wished to hold their quid account.
3. A quantity of quid would be deposited in each individual's account to allow him or her to buy goods and services. They would transfer the quid they received to each other and to companies using their mobile phones for small amounts and from their computers or through their banks for larger sums. Quid would only exist electronically. This is essential so that quids can fully controlled and easily be removed from circulation.
4. Firms would also have quid accounts. It is not yet clear whether they too should be given an initial float or be expected to earn their float by supplying the public. It would be up to each company to tell prospective customers which goods and services they were prepared to supply for payment entirely in quid and, if not, what the price was in a combination of euros and quid. Equally, it would be up to employers and employees to negotiate how what proportion of wages could be paid in quid.
5. The government would announce that the tax due on quid transactions and earnings could be paid in quid. It, like everyone else, would have to work out a way of handling the two units.
6. Quid accounts would not be confidential; the issuing body would have access to them, regardless of the bank which provided them. so that it could manage the system. The units in each account would not belong to the accountholder. They would be there purely as a measure of value. Anyone wishing to save should use the euro instead.
7. As the volume of business being done in quid increased, the issuing body would

watch the velocity of circulation closely and, once it had crossed a previously

> announced threshold, it would give more quid into circulation by adding them to the accounts of those who had the highest velocity themselves. Anyone whose velocity fell below a certain level would have a percentage of their quid removed. The aim would be the keep the supply of quid tight to maintain its value. If the euro economy began to pick up and less trading in quid was done, units would be removed from the slowest accounts.

Presented as an emergency measure to avoid a default, this system would attract much less criticism from the European Commission, the ECB and the other member states than a decision to leave the eurozone and revert to a national currency. The government would point out to its partners that if the global economy recovered and euro flows increased, the use of the quid would naturally decline and that this would mean that they were automatically be withdrawn from circulation. Eventually the system would wither away entirely because companies would not want to bother with keeping their books in two currencies and would stop accepting quid. Privately of course, the government might regard the quid as long-term hedge against a permanently depressed eurozone in which the euro continued to be scarce because it was issued as a debt.

Besides being more acceptable than leaving the eurozone to Brussels, the quid system would be very popular with the public. They would credit the government with responding well to the crisis and with giving them something free. After months of what has been seen as the bailing out of the better-off, the state would be seen as doing something for ordinary people. Anyone with euro debts would immediately find that their problems were eased because, now that they had the quid for some of their expenditure, they could use their euros to keep up payments to their bank. This would immediately cut the banks' bad debts and thus the risk of the state's guarantees being called.

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i http://news.bbc.co.uk/1/hi/uk_politics/7817623.stm
ii http://www.guardian.co.uk/world/2008/oct/09/zimbabwe
iii BBC World Service "Analysis" Thursday, 22 January 2009, 00:41 GMT