EDITORIAL: Liquidity Trap or Safety Trap?

Many among the academic and central bank communities are willing to describe the current situation in most advanced economies - where the key monetary policy interest rate is at its (zero) lower bound - as a Keynesian liquidity trap. And indeed, if viewed particularly through the lenses of Keynesian economics, the current situation seems to share many of the features of a Keynesian liquidity trap: central-bank cash injections into private banks have limited effects on interest rates so that (conventional) monetary policy becomes ineffective. In effect, because of free disposal, the zero lower bound prevents nominal interest rates from taking negative values. The key underlying macroeconomic factor driving the economy into a liquidity trap is a large deflationary aggregate demand shock. Such a shock is more often than not either propagated or triggered by a financial crisis. The combination of zero lower bound on nominal interest rates and low actual and expected inflation rates, which usually prevails during liquidity trap type situations, as well as a nearly consensus view about the difficulty of getting out of a trap, seems to be that the real interest rate is still too high relative to the equilibrium or natural real interest rate. If so, inflating the economy, i.e. generating higher inflation expectations on a temporary basis via policy actions in order to reduce the real interest rate, appears to be an appropriate policy strategy. This obviously may pose a serious policy problem for central banks, since theoretically at least generating temporarily higher inflation expectations through monetary policy may be extremely difficult and higher inflation expectation, even if perceived initially as temporary, may seriously challenge central banks’ credibility in pursuing stable prices. Not least, because the latter point is an indication that central banks do not operate in a vacuum: fiscal and monetary policy regimes and the interaction of the related policies, in the end, determine the monetary policy space and its capacity.

Recent literature has, however, introduced a competing view to the liquidity trap as regards the key drivers that take the economy to the zero lower bound and keep it there. This view is based on the notion of a safety trap, which emerges from the following reasoning. One of key structural features of the global economy during the recent years seems to be a

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2 The text follows Caballero and Farhi (2014) closely.
shortage of safe assets. This excess demand for safe assets was the main macroeconomic driver of the financial engineering underlying the subprime crisis, and it was the key factor affecting the spike in funding costs in the euro-area problem countries. Furthermore, this shortage has introduced new constraints on monetary and fiscal policy.

In its most acute manifestations, a shortage of safe assets can generate macroeconomic outcomes quite similar to those found in liquidity-trap models, such as severe recessions and (safe) interest rates, so low that bonds and money become perfect substitutes (as a store of value). As noted by Caballero and Farhi (2014, p. 2), despite the similarities, there are important differences between liquidity and safety traps. These differences have implications for the relative effectiveness of different economic policies and potential market solutions to the underlying problem. For one, forward guidance, i.e. commitment to low future interest rates once the economy recovers, is usually more effective than quantitative easing in the context of a standard liquidity trap argument, but the opposite holds in a safety-trap context. Quantitative easing, e.g. in the form of swapping risky private assets for safe public debt, reduces the excess demand for safe assets.

On the other hand asset bubbles (market solutions) and public debt are both effective in a liquidity trap, whereas only the latter is effective in a safety trap. The intuition here is that a shortage of safe assets is equivalent to a lack of or deficit in a specific form of wealth, namely safe wealth. If the government is not constrained by its fiscal capacity, it has a comparative advantage in supplying safe assets. Available fiscal capacity is critical, since it determines how much public debt the government can credibly pledge to honour, should the economy be subject to a major adverse macroeconomic shock in the future. Finally, forward guidance and financial bubbles, by increasing risky wealth, fail to stimulate an economy that is in a safety trap, because they tend to be drained away by wider spreads.

As Caballero and Farhi argue (2014, pgs 3-4), their model of the safety trap is related to a number of important issues in economics and finance: the identification of a shortage of safe assets as the key macroeconomic fact (via the literature on aggregate liquidity), the pricing of government (short-term) securities using standard asset pricing models, short-term debt and systemic instabilities, and the literature on liquidity traps. An interesting speculation relates to the idea that liquidity traps and safety traps are complementary in the sense that aspects of a safety trap are dominant
during the most severe phases of crises and deep recessions, which gradually mutate into a liquidity shortage or trap as the recovery grudgingly evolves. Another idea to ponder is the potential implications of macroprudential supervision, in that the global safe asset deficit can increase due to the need for economic agents to hold increasing amounts of safe assets, unless the structure of the global financial system improves so as to timely increase the supply of these assets.

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### Unconventional monetary policy measures also affecting emerging economies

The Bank of Finland Institute for Economies in Transition (BOFIT) hosted the Asian Economic Panel meeting on 9–10 June 2014, in cooperation with, among others, the University of California (Davis). The Asian Economic Panel normally includes both more scientific presentations and introductions directly related to different policy issues. The content of the event was also similar this time, and the first day was additionally concluded by a panel discussion on unconventional monetary policy measures and possible effects of their reversal. The panel discussion was chaired by Professor Wing Thye Woo (University of California, Davis), and the panellists were Seppo Honkapohja, Member of the Board of the Bank of Finland, Professor Kiyohiko G. Nishimura (Tokyo University, former Deputy Governor of the Bank of Japan) and Chalongphob Sussangkarn (Thailand Development Research Institute, former Finance Minister of Thailand).

From left to right: Seppo Honkapohja, Kiyohiko G. Nishimura, Chalongphob Sussangkarn and Wing Thye Woo as well as Michael Plummer, Yuan Yangzhou and Zhichao Zhang.

A varied range of themes were addressed at the panel discussion. The impact of major economic regions’ divergent monetary policy on capital movements and, possibly, on exchange rates was of great concern. These concerns also affect emerging economies, which need to ensure that they have a sufficient array of effective economic policy tools in place to respond to the prospect of increasing capital flows. The last twelve months have shown that, for example, mere expectations of changes in US monetary policy are enough to redirect the flows of capital.

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3 Caballero and Farhi (2014, p. 32).
The Asian Economic Panel meeting dealt with different Asian economies in a diverse manner. Among others, Jan Fidrmuc (Brunel University) presented a study on the relationship between changes in employment and changes in GDP in China, in other words, a study on how Okun’s law operates. Research findings indicate that the relationship between employment and GDP broadly follows Okun’s law in those regions that have gone further ahead with economic reforms and already have higher living standards. Deunden Nikomborirak (Thailand Development Research Institute) looked at ASEAN countries’ economic integration from several different angles. Despite ambitious plans, the countries’ integration has not advanced very fast. It also seems that progress will be slow in the years ahead. This may be due, in part, to the fact that the United States and China, among others, are more important trading partners for all ASEAN countries than are other ASEAN countries.

The programme of the Asian Economic Panel is posted online at: http://www.suomenpankki.fi/bofit_en/bofit/ajankohtaista/uutiset/Pages/AEP2014.aspx

Iikka Korhonen
Events

Expectations in Dynamic Macroeconomic Models
7–8 August 2014, Bank of Finland, Helsinki
Organized by Bruce McGough, Bruce Preston and the Bank of Finland

The conference aims to bring together leading experts in the modeling of expectations in dynamic macroeconomic models. Please see the programme on the conference site http://www.suomenpankki.fi/en/tutkimus/konferenssit/konferenssit_tyopajat/Pages/ExpInMacroModels2014.aspx

Entrepreneurial finance, innovation and growth
23–24 October 2014, Helsinki
Organized by the Bank of Finland and CEPR

The Bank of Finland and CEPR will jointly organise a two-day conference on Entrepreneurial finance, innovation and growth. Start-ups with high growth potential, and small and medium sized firms are vital to any economy. They are in the core of innovation activity that is a key to more efficient resource allocation, job creation and, ultimately, economic growth. They also provide the critical flexibility for an economy in the face of adjustment challenges brought by external shocks. In taking advantage of new business opportunities identified by entrepreneurs, financial conditions and other economic institutions play a critical role. There is an ongoing debate in Europe and elsewhere on whether the structure and behaviour of the financial system, and whether economic environment more generally are conducive to entrepreneurial effort, innovation and new business generation. Academics can best contribute to this debate by pursuing high quality, timely research on issues relevant to and factors affecting new venture.

For more information, please visit the conference site http://www.suomenpankki.fi/en/tutkimus/konferenssit/konferenssit_tyopajat/Pages/BoFCEPR2014.aspx

Conference on China’s financial market liberalization
18–19 September 2014, Bank of Finland, Helsinki
Organized by Bank of Finland Institute for Economies in Transition (BOFIT), City University of Hong Kong, Department of Economics and Finance, and Research Center for International Economics

China has already taken many steps to liberalize its domestic financial markets and cross-border financial flows. However, many important steps remain to be taken, and therefore it is of interest to assess the current state of financial market liberalization and its future path. The conference invites researchers to present their original works on issues related to the liberalization of China’s financial markets.

The programme and the accepted papers will be posted on the conference site http://www.suomenpankki.fi/bofit_en/tutkimus/tyopajat/Pages/China2014_Helsinki.aspx

Banking in Emerging Markets: Challenges and Opportunities
Moscow, October 3, 2014

The Center for Institutional Studies, National Research University Higher School of Economics (CInSt HSE), with the support of the Bank of Finland Institute for Economies in Transition (BOFIT) organizes the 4th Annual CInSt Banking workshop "Banking in Emerging Markets: Challenges and Opportunities". The workshop will be held on October 3, 2014, in HSE, Moscow. It is aimed at bringing together scholars involved with various aspects of banking in emerging markets, including but not limited to those of Central and Eastern Europe, CIS countries, Latin America and China.
Bank of Finland Research Seminars

Research seminars continue in the autumn. Please follow the seminar site. Research seminars organized by the Bank of Finland’s research unit are held on the first Thursday of the month at 13.30–15 in Rauhankatu 19, 3rd floor big meeting room (unless indicated otherwise). Research seminars are open to all interested parties. Please register in advance at seminars@bof.fi by noon of the preceding day.

BOFIT Seminars

For seminars organized by BOFIT, please visit the seminar site. The seminars are open to all economists interested in the subject areas covered. You need to pre-register for the seminars at bofit@bof.fi.

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