

BURNING BRIDGES AND HALFWAY HOUSE

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March 21, 2005

Liquidity trap

The corner-stone of my deflation theory is the observation that there is a double-bias caused by the central bank's open market operations as it removes risks from bond (but not from commodity) speculation, and rewards bond bulls (while punishing the bears) [4]. This double-bias distorts the economy in favor of deflation. It is palpable only when deflation is present in the economy in the first place, in which case it is made worse than it need be by prompting speculators to buy bonds in tandem with the central bank. Interest rates fall and through the mechanism of linkage prices fall, too, as the flow of money from commodities to bonds accelerates. In the worst-case scenario a vicious circle is activated and the economy plunges into depression.

The question arises why mainstream economists didn't discover the deflationary bias and alert central bankers to mend their ways. The answer is that they did. However, they had to proceed gingerly. The bridge of the gold standard leading back to monetary sanity and rectitude had already been burnt. They were looking at the incurable congenital disease of the regime of irredeemable currency. Mainstream economists could not talk openly about the dangers of snowballing bond speculation without exposing the fatal inner contradictions of their monetary regime. The diagnosis therefore had to be couched in the language of the liquidity trap.

The term originated with Keynes himself who, in the second half of the 1930's, noted that his contra-cyclical prescription to inject new money in the economy through central-bank purchases of bonds in order to combat falling prices wasn't working. In fact, it produced just the opposite effect of what he had hoped. Deflation got worse, not better. As always, Keynes was ready with the explanation. The disease was so advanced that the patient didn't readily react to medication as it was supposed to. The first dose of money-injection administered by doctors from the central bank could not spread through the diseased organism but, instead, accumulated in a "liquidity-trap". Nevertheless, Keynes was for continuing the money-injection therapy. He was confident that, ultimately, prices would move higher, as they had to according to the Quantity Theory of Money. Of course, Keynes would not admit that the main cause of the malady was the surgical removal of the gold standard at his instigation earlier in the decade.

Pallas Athena born in full armor

As the ownership of monetary gold was made illegal in 1933, the only competitor to government bonds was removed from the arena. Owners of monetary gold were forced by the strong arm of the government to invest in government bonds — not a very pretty sight in itself, even if the matter ended there. But the matter did not end there. As holders of gold were competing for the limited supply of

government bonds, which rightly or wrongly they considered as the safest thing to have second only to gold, bond prices were driven to unprecedented heights and interest rates were plunged to unprecedented depths. The federal funds rate even went negative. Member banks were actually paid a premium for taking money overnight from the Federal Reserve banks.

At that point in time bond speculation was still unknown in the United States. But just as Pallas Athena was born in full armor when she sprang from the skull of Zeus after her father's bizarre pregnancy ended in a splitting headache, so did bond speculators, a whole army of them, spring from the skull of Keynes in a remarkable replay of the mythological story. The speculators did not need any training. They were ready. They did not need any capital either. It was made superfluous by the forcible removal of gold as a competitor of government bonds. Speculators (read: the banks) were literally paid by the Fed to take the money to buy the bonds. Thereafter their only worry was to keep writing up their assets month-after-month, quarter-after-quarter. Why should the banks risk their money by lending it to ailing business on their way to recovery, if they could invest it in steadily appreciating bonds, risk-free? The world had never seen anything like that before: banks betraying their mission to finance business and shepherding their resources into bond speculation. And why not? Not only did the continuous injection of irredeemable currency into the economy by the Fed make bond speculation risk-free, it actually guaranteed capital gains on their bond portfolio, *on the top of the interest-income*. The stock-market craze of the Roaring Twenties was nothing in comparison. The largest speculative orgy in history was on. It was in the 1930's, and it was in the bond market.

Of course, the theory of liquidity traps does not mention bond speculation. The s-word is taboo. It talks about liquidity being mysteriously siphoned off and trapped. As the central bank fighting recession drove interest rates close to zero, the fruits of any further monetary expansion would be stuck away in mattresses and cookie jars where they could do nothing for the economy. The process is described in detail in the first edition of Samuelson's textbook published in 1948 used in training Keynesian economists.

Truth be told, the "fruit" is not put in mattresses and cookie-jars. It is taken by the speculators to the bond market where the miraculous multiplication of money is taking place. But you are not supposed to utter the s-word as it would conjure up the fatal flaw of the regime of irredeemable currency.

The chapter on the liquidity trap did not stay in Samuelson's textbook for long. It was deleted from subsequent editions. Interest rates were edging up, and the author didn't think that there was a danger for them ever to come down again to the vicinity of zero. Surely inflation would see to that. The Fed convincingly demonstrated its power in ending recession after recession. There seemed no reason to doubt that it could always do so whenever needed [1].

The regime of irredeemable currency was firmly implanted in the economy, and the central bank could control practically everything with the possible exception of the weather.

The interest-targeting cabal

While out of the textbooks, the liquidity trap was not out of the ivory towers. It was still being discussed in the rarified atmosphere of academia. The world

center for liquidity-trap studies and for the inflation-targeting cabal is the Woodrow Wilson School at Princeton University in New Jersey. Under the leadership of department head Ben Bernanke a team consisting of Paul Krugman, Lars Svensson, and Mike Woodford has been busy investigating the liquidity trap and finding ways to unplug it through inflation-targeting should it get clogged again. The Princeton plumbers worked out esoteric mathematical models to show that, indeed, the danger of liquidity traps was real. Here is the verbalization of the mathematical hocus-pocus. (A less polite expression, the title of [1], could also be used. I stay with the more polite version. As the author points out, according to Goodwin's Law the party that blinks first and mentions bodily wastes loses the argument.)

The cabal turns on the concept of "potential output". It is defined as maximum output consistent with a stable inflation-rate. (Please don't heckle the plumbers with interjections that a stable inflation rate is an oxymoron.) If actual output exceeds potential, then the rate of inflation will rise; if below potential, then it will fall. In the latter the Princeton plumbers sniff great danger. Suppose that, for whatever reasons, the economy is operating below potential output (there is an "output-gap"). Then the situation is no longer stable. We are staring right into the liquidity trap. Disinflation makes inflationary expectations fade, leading to more disinflation, whereupon inflationary expectations fade more. The vicious circle is on and pushes the economy right into the liquidity trap. Once that happens, the central bank can pump money into the economy as much as it wants, it will all end up in the liquidity trap. The output-gap will worsen, leading to even lower inflation, and so on. The thing to worry about is the spiral of declining output relative to potential, and fading inflationary expectations [1].

Krugman adds the punchline: "zero is not a big number whether for growth, or whether for inflation" [2]. In plain language, if you want growth, you had better target inflation, and *target you must well above zero*. The trouble with fading inflationary expectation is that it jerks the rug from underneath the interest-rate structure.

Please note how the Princeton plumbers studiously avoid any reference to bond speculation, a *hard* fact of the economy, and substitute for it "fading inflationary expectations", a *soft* economic euphemism.

The Japanese bubble bursts

So when the Japanese bubble burst, the Princeton plumbers were ready. The Fed quickly tapped Ben Bernanke, bringing him to Washington and making him the heir-apparent to Greenspan. Recent rumors have it that the threat of the Japanese sickness is so serious that Bernanke will have to be moved from Constitution Avenue to Pennsylvania Avenue, right into the White House, to head the council of the President's economic advisors. Well, we won't have to wait too long to learn where upstairs the head-plumber will be kicked.

By 1996 Japan looked an awful lot like a country in a classic liquidity trap. And that was scary. It meant that "our grandfathers were not as stupid as we thought" in the words of Princeton plumber Paul Krugman, who is moonlighting as staff writer for *The New York Times*. A 1930-style slump may not be that easy to fix, after all. A disease we had thought was under control reappeared in a form resistant to all the known antibiotics. Japan's trap was real.

But if Japan remains stuck in that trap, who cares? Well, you should. Not only is Japan the world's second largest economy; until recently it seemed to be the economy of the future. Worse still, if it could happen to Japan, why not to us? [1]

As the Princeton plumbers must not utter the s-word in public, talking about the mechanism whereby depression can metastasize across the Pacific is taboo, too. This mechanism is the notorious yen-carry trade, or bond speculators doing arbitrage between the Japanese and the American bond markets. They sell the ultra-high-priced Japanese bonds and buy the relatively cheap American. The net effect is to push interest rates in the United States down to the unprecedented low levels prevailing in Japan.

Can Deflation Be Prevented?

This is the title of an article [3] also written by Paul Krugman six years ago when he was still at MIT, from which the following quotations are taken. What gives it timeliness is that those six years have not solved any of the underlying problems but, in many ways, the economy has deteriorated in the wake of the continuing exponential growth of debt and its symbiotic parasite, bond speculation.

The cover story from *The Economist* makes it more or less official. Deflation, not inflation, is now the greatest concern for the world economy. Over the past year, producer prices have fallen throughout the advanced world; consumer prices have been falling for the last 6 months in France and Germany; in Japan wages have actually fallen 4 percent over the the past year...

“So far none of these price declines looks anything like the massive deflation that accompanied the Great Depression. But the appearance of deflation as a widespread problem is disturbing, not only because of its immediate economic implications, but because until recently most economists — myself included — regarded sustained deflation as a fundamentally implausible prospect, something that should not be a concern.

“The point is that deflation should — or so we thought — be easy to prevent: just print more money. And printing money is normally a pleasant experience for governments. In fact, the idea that governments have a hard time keeping their hands off the printing press has long been a staple of political economy; dozens of theoretical papers have argued that the temptation to engage in excessive money-creation causes an inherent inflationary bias in fiat-money economies. It is largely to combat that presumed bias that most of the world has accepted the notion that monetary policy should be conducted by an independent central bank, insulated from political influence — and has been written into the charters of those central banks that they should seek price stability as their main, often only, goal.

“Yet here we are, with deflation turning out to be a serious problem after all — and with policymakers finding that it is not as easy either to prevent or to reverse as we all thought.

“How can this be happening? What does it imply for policy? The purpose of this note is to argue that more or less conventional economic theory actually does suggest some answers to these questions — but that these answers fly in the face of conventional policy wisdom. And because the answers are so hard to accept, deflation is indeed a real risk.”

We may skip the hocus-pocus part of the article and go directly to its conclusions.

“The obvious answer to sustained deflationary pressures, then, is the now-notorious proposal for ‘managed inflation’... But the idea *sounds crazy*, and that is a problem. How can we get finance ministers and central bankers, who have spent their whole careers preaching the evils of inflation and the virtues of price stability, to accept the idea that price stability may not be an available option?

“For if deflationary forces are as powerful as they are in Japan — and may soon be in the rest of the world, if *The Economist* is right — there is no middle ground... Attempts to find a halfway house — to aim merely for stable prices rather than sufficiently high inflation — will be doomed to failure.

“In short, if you really believe that deflation is now a global threat, you should also believe that only policies lying outside of the realm of what is conventionally regarded as responsible will contain that threat. And because unconventional thinking is not what one expects (or, in normal times, wants) from finance ministers and central bankers, there is now a real risk that deflation will indeed become a global scourge.”

Thus concludes the article. It nicely explains what has happened in the intervening six years. The powers that be were scared by the deflationary threat much more than they ever admitted. Without any hesitation they took the advice of Krugman, abandoned policies “conventionally regarded as responsible”, unilaterally betrayed their mandate, burnt the halfway house of price stability, and hit the warpath of inflation, euphemistically calling it “inflation-targeting”.

One irresponsible monetary policy deserves another

What Krugman conveniently ignores is that inflation may not be ‘manageable’ like a pet dog. More like a hungry tiger smelling blood, it could get out of hand following reckless increases in the money supply. No less than burning bridges, burning halfway houses is not a very good idea. Mainstream economists burnt the bridge of the gold standard making it the whipping boy for the Great Depression. Through that bridge we could have retreated to monetary rectitude after the insane experiments with the fiat dollar. Now they burn the halfway house of price stability, too. Where will the Fed find shelter after the tornado of runaway inflation has struck?

The seriousness of the problem cannot be overstated. A steep rise in interest rates at this juncture would be the horror of horrors. Normally higher interest rates would strengthen the value of the currency as they attracted foreign

investors. Not this time. Apart from the problem of pricking all the bubbles in the economy starting with the housing bubble, and ballooning the budget deficit into outer space, there is an even larger and more immediate problem. And that is the effect that steeply rising interest rates have on the value of bonds, widely held at home and abroad. The effect is inevitable and instantaneous. Higher interest rates make bond values collapse.

You have to be very clear in your mind about this, so I spell it out. The dollar losing value on the foreign exchanges because of the trade gap is one thing. Dollar-bonds losing value due to higher interest rates is another thing. Nevertheless it is entirely possible, and right now appears highly probable, that the two losses will be inflicted simultaneously. Losses on bonds will compound the loss on the dollar. The compounded loss shall exceed the critical mass of bearable losses, and will trigger a chain reaction of further losses. The confidence in the dollar will be fatally and irreparably shaken, domestically as well as internationally.

How likely is that to happen? In my opinion not very likely. The Fed must have a contingency plan to prevent a steep rise in interest rates. Krugman has convinced us that the money-managers at the Fed have got rid of their last scruples, if they ever had any. Paraphrasing him, if you really believe that runaway inflation is now a global threat, you should also believe that only *policies lying outside of the realm what is conventionally regarded as responsible* will contain that threat. One irresponsible monetary policy deserves another. The contingency plan to prevent a steep rise in interest rates will have to involve a conspiracy between the Fed and the Bank of Japan to punish speculators short-selling the dollar and dollar bonds. There is nothing else left in the Fed's bag of tricks but the check-kiting scheme with the Bank of Japan that could hold back the forces of monetary destruction waiting in the wings. Never mind that it is "conventionally regarded" as irresponsible. Never mind that it is illegal. Never mind that it is criminal.

Nothing else will defer the day of reckoning.

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