“It’s baaack: Japan’s slump and the return of the liquidity trap”

P. Krugman, 1998

Discussion

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Agenda

- The key message of the paper

- Reasons for praise:
  - A revived interest
  - The enriched IS-LM approach
  - The focus on credibility

- Reasons for doubts
  - Is it a liquidity trap?
  - Which role for fiscal policy?
  - Credible policies?
The key message

- Japan was at the time of the paper in a liquidity trap:
  - The nominal interest rate was close to zero, so that conventional monetary policy was ineffective due to the perception of monetary base and bonds as perfect substitutes;
  - However, the real interest rate was far above zero (deflation).

- A liquidity trap involves a credibility problem:
  - The public expects monetary policy to be only temporary
  - Monetary policy becomes ineffective
  - If central bank could behave as “irresponsible”, i.e. not targeting price stability in the future, monetary policy would regain its grip.
Impact of monetary expansion (SR)

A) Liquidity Trap

B) “Normal” Conditions

Money Market

IS-LM

Goods Market
Reasons for praise

Three major interesting features:
1. Revived interest for the topic
2. Enriched IS-LM approach
3. The focus on credibility

1. A revived interest
   - Not many papers dealt with the topic until Krugman’s work
   - Afterwards, several contributions, both in favor or strongly disagreeing
   - Interesting topic on which possible lack of understanding: extensions of old models to deal with it
   - Potential emergence of liquidity trap elsewhere?
2. The “enriched” IS-LM approach
   - Starting point: the traditional Keynesian model
   - Inclusion of expectations (crucial in a model credibility-based) and intertemporal consistency
   - Unconventional results, unconventional solutions: integrated policy, new way of approaching the solution

3. The focus on credibility
   - Credibility problem: monetary policy is effective only if perceived as permanent
   - Revert traditional credibility problem: aim at being irresponsible (increase price permanently)
   - Managed inflation: inverted version of stability target
Reasons for doubts/1

- Three main critiques
  1. Is it a liquidity trap?
  2. Which role for fiscal policy?
  3. Credible policies?

1. Is it a liquidity trap?
   - Alternative view: credit crunch
     - Contraction of supply of credit
       - Decline in bank capital, skepticism of domestic and foreign investors
       - Cautious attitude towards lending
Reasons for doubts/2

2. Which role for fiscal policy?
   - No clear impact
   - Is it effective when the propensity to savings is high (Keynesian multiplier)?
   - Negative effect on public accounts

3. Credible policies?
   - BoJ’s reputation of low inflation policy and aversion to numerical targets
   - No commitment for a permanent increase in money supply
BoJ policy: “wait and see”

- Recapitalization of banks and safe financial system
- Expansionary monetary policy (low interest rates)

Source: our elaboration on OECD.stat, Economic Outlook – December 2009 – Annual Projections for OECD countries.
Further evidence

**Fiscal Policy**

Source: our elaboration on OECD.stat, Economic Outlook – December 2009 – Annual Projections for OECD countries.
Deflation

Source: www.tradingeconomics.com
References


