MACROECONOMIC POLICY IN RESOLVING THE "LIQUIDITY TRAP" PROBLEM

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"Liquid trap" that was initially introduced by Keynes (1936) still troubles researchers ranging from Friedman and Krugman. Krugman describes the "liquidity trap" as «in which monetary policy loses its grip because the nominal interest rate is essentially zero, in which the quantity of money becomes irrelevant...» [2]. Literally it says that "liquidity trap" is the financial presentment of economic crises. In this thesis the author provides chronological macroeconomic policy in addition to econometric calculations in order to resolve the "liquidity trap" problem. To fully understand, Chart No. 1, visualises and gives a more precise definition of the "liquidity trap" and how it arises. Let's imagine that country A sets a certain interest rate (i^*) (whether on bonds or loans). When the economy slows down, the monetary policy of the country A represented by the Central Bank provides commercial banks with money (M_{s1}) in which case the money supply increases and, consequently, the nominal interest rate on loans decreases that allows enterprises and individuals to borrow more loans. At every economic slowdown, the Central Bank's intervention (M_{s2}, M_{s3}) increases the money supply in the market and reduces the interest rate to almost a zero. The continuation of the money intervention (M_{s4}, M_{s5}) to stimulate loan consumption by population lets the money supply to increase but the interest rate cannot fall further and become negative. Thus, the "liquidity trap" occurs in the economy where more money does not lead to ever-decreasing interest rate (for loans; for deposits and investments - an increase of the interest rate), and monetary policy becomes ineffective with an increased money supply. The author applies the IS - LM model where LM-curve becomes infinitely elastic parallel to the Y-axis since the interest rate i^* is at the very minimum to describe why investors get rid of bonds and start to invest into more profitable assets. The emerging imbalance between the commodity and money markets rises an inflation. In other words, when the economy is in the "liquidity trap" it is quite true that inflation will be higher than the nominal interest rate, and, consequently, the purchasing power of the income received will be less than the initial investment. Accordingly, the question is asked: where those funds are invested to? To the above-mentioned profitable assets such as production, i.e. to the commodity market. Thus, the prices of goods increase, and a chain of consequences follows. As the goods of domestic producers have become more expensive, consumers prefer to buy imported, more affordable goods. Consequently, the local manufacturer begins to suffer losses. In order to avoid the loss of a niche, an entrepreneur reduces the cost for raw materials and labor. The unemployment rate grows. This moment - the growth of inflation and production cuts - is called stagflation. In fact, the economy is in a state of depression. If a country has fallen into the "liquidity trap" then what should it do to achieve positive economic performance? The author criticizes the use of Friedman's fiscal policy right away when "liquidity trap" emerges. It is true that the fiscal policy removes surplus funds from the commodity market (IS-curve) and returns them to the central bank through increased taxes and interest rates on loans. The turnover of money supply in the country decreases and, consequently, the economy stabilizes. On the one hand, Friedman's policy is logically correct because the money

supply is significantly reduced, and the equilibrium point between the markets returns to the optimal balance $(i_0 Y_0 \rightarrow i_1 Y_1)$. On the flip side, the shortcomings of this system have serious consequences. First, the tax increase causes high prices for local production. Second, according to Chart No. 2, after the introduction of the Friedman's fiscal system, the base interest rate remains unchanged, and the volume of output reaches Y^*. Therefore, the strategy proposed by Friedman, in fact, conquers only inflation and does not encourage economic development. Marx, Keynes and Krugman aver that during inflation only the devaluation of the national currency is the solution to the "liquidity trap" [1, 2]. However, in their researches, it was assumed that the devaluation occurs naturally. In this thesis, the author reviews the devaluation of the national currency as artificially established by the central bank that creates favorable conditions for local producers, especially for export-led enterprises. Econometric model (on the example of TOYOTA Company) in this study showed that the devaluation of the national currency has a positive impact on the company's revenue. Pay attention to how fast Japan's GDP had grown after adopting the national currency devaluation strategy (on average 30-35% per year for the periods 1985 to 1995) [3]. Normally, in countries there is an average of 5% of GDP growth. A high percentage of the devaluation plays antagonistic role in the development of country's economy. Abuse of the devaluation causes negative effects with serious consequences such as overproduction and excessive dependence on foreign markets that face shocks every 5-10 years. Thus, only in this case, the author recommends the implementation of fiscal policy for stabilizing the economy. Appreciation of the national currency will direct export-led manufacturers to saturate domestic market, and the withdraw of excessive money supply from commodity market and their reinvestment into the government projects will improve the infrastructure and service sector.

Источники и литература

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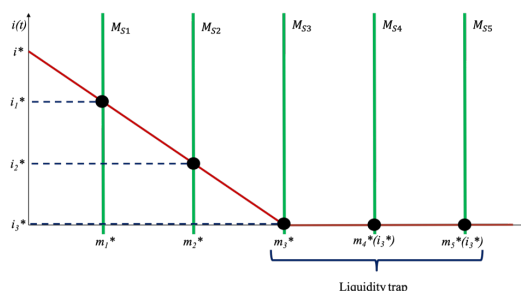
3) World Bank Open Data: https://data.worldbank.org

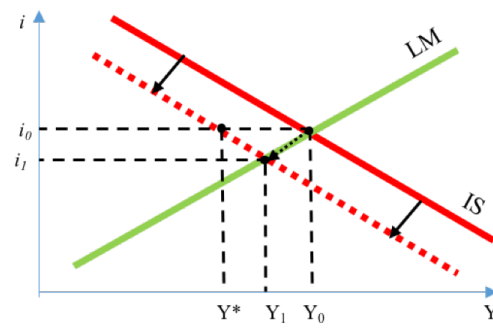## Иллюстрации

Рис. 1. The process how "liquidity trap"occurs

Рис. 2. The IS-LM model illustrates fiscal policy