

Most recent discussions take a highly accessible paper by Noble laureate Paul Krugman as their starting point.⁵ The implication of his model is that there is indeed little that conventional monetary policy can do in the here and now. Printing more money to buy more bonds makes no difference.

There is a way, however, that a central bank might still work its magic, namely through expectations. This means convincing households and firms that you will not just expand money supply today, but continue to do so tomorrow. If it succeeds, inflation expectations will rise, allowing real interest rates to fall and stimulating investment. Of course, this only shows that monetary policy might work, not that this is the best option, or even a particularly good path out of the liquidity trap.

Once interest rates are at zero, short-term bonds and money are close to perfect substitutes. Conventional monetary policy loses much of its potency. Even if a central bank somehow succeeds in pushing nominal interest rates on bank deposits into negative territory (an option section 2 looks at), this would simply make cash even more attractive than bonds as a store of value. So, if a central bank keeps on buying short-term bonds, we would still have the same problem – it would keep on buying, without those purchases having any impact.

But what if the central bank starts buying longer-duration government bonds? Couldn't this help by reducing the term premium? And surely, QE might squeeze spreads, either by central banks buying corporate bonds directly or by pushing private investors into higher risk assets? And finally, all this should reduce funding costs for companies building new factories, should it not? Also, might the rise in asset prices of all sorts not make households feel wealthier, boosting consumption?

Well, a resounding "Maybe" to all of the above. Something along these lines has happened in practice. Central banks used to be lenders of last resort. Increasingly, they have instead become the buyer of last resort. This certainly worked in terms of reducing longer-term government bond yields – ballooning central bank balance sheets coincided with falling bond yields.

⁵ Krugman, Paul R. "It's Baaack: Japan's Slump and the Return of the Liquidity Trap." *Brookings Papers on Economic Activity*, 1998, 29(2), pp. 137-205.

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