

# Economist Robert Shapiro Springs the Bad News about the Liquidity Trap

Published: Tuesday, 16 Nov 2010 | 4:24 PM ET

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Two short words can evoke terror in the heart of any true Keynesian: Liquidity Trap.



Source: NDN.org

Dr. Robert Shapiro

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lending occurs."

I recently spoke with Dr. Robert Shapiro about the overall state of the economy —and the dreaded liquidity trap scenario. Dr. Shapiro was Under Secretary of Commerce for Economic Affairs during the Clinton administration, and the principal architect of President Clinton's 1992 economic program.

The formulas representing the liquidity trap concept are both [dizzying](#) and varied — [but Dr. Shapiro breaks the idea down into a highly digestible form](#):

"You know you're in a liquidity trap when—no matter how low the interest rates are—lending doesn't occur. Or very little

That's really the crux of a very complex concept: When you're stuck in a liquidity trap, banks don't want to lend and businesses and consumers don't want to borrow.

So how does the liquidity trap scenario occur?

Let's first take a look at the way things typically work when the economy is functioning in its usual state.

As Dr. Shapiro explains, "Normally, the way we drive lending— and by driving lending we drive the things that people borrow money to buy— ... is lowering interest rates."

Intuitively, this idea makes perfect sense. Take, for example, the most important credit decision most people make during the course of their lives: Buying a home.

Most of us would feel a lot better buying a house when interest rates were low rather than high—and rightly so. Other factors being equal, a 5 percent fixed rate mortgage is a much better deal for a home buyer than the same mortgage at 10 percent—and quite evidently so —as anyone who has ever looked at an amortization table can tell you. (By 'other factors being equal', I'm of course referring to the purchase price, your income, your expectations of the housing market, etc.)

The same is true with nearly all purchasing decisions in the broader economy. As Shapiro explains, "Things like buying plants and equipment by businesses, and buying homes and appliances by individuals," are governed by the same rules and economic logic. Lower interest rates make purchases more appealing, while higher interest rates drive down demand for the things bought with credit.

"Credit and money work the same way as virtually anything else," Shapiro says.

We all understand the basic rules of supply and demand: The amount of something we're willing (and able) to buy increases as the price drops. This holds true for shoes, vacation homes – and, of course, for money.

In reference to the demand for money, Shapiro says "Normally, we can increase that [demand] by lowering its price— by lowering the interest rate." But our ability to do just that can evaporate in the liquidity trap scenario:

"There are some conditions under which banks are unwilling to lend—even if they would normally earn profits by doing so—and conditions under which people are unwilling to borrow—regardless of how low the cost of money is."

And, when you think about it, that's really two sides of the same economic coin.

In a liquidity trap, borrowers are fearful to buy things with borrowed money—no matter how far the interest rates have dropped. And lenders don't want to lend— even though the rates at which they can get capital are extremely low.

And there, as Shapiro explains, there is ample historical precedent for exactly this scenario:

"We first encountered this in the 1930s. And we are encountering it today. How do we know? Because we have been at near zero interest rates for a long time now. And business investment has not picked up.

And consumer and home sales are not picking up."

Remember, the scary part about this scenario, as it's traditionally understood, is that the whole cycle can become a self-reinforcing downward spiral. After all, it's called a liquidity 'trap' for a reason.

In Part II with Dr. Shapiro, we explore the causes of the liquidity trap scenario and discuss its potential solutions.

More from Dr. Shapiro can be found at [his website](#).

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