THE GREAT U.S. LIQUIDITY TRAP OF 2009-11:
ARE WE STUCK PUSHING ON STRINGS?

Robert Pollin
Department of Economics and
Political Economy Research Institute (PERI)
University of Massachusetts-Amherst
pollin@econs.umass.edu

August 2012

Forthcoming in Review of Keynesian Economics

JEL CODES: E44, E5, E65

ABSTRACT: After the onset of the Great Recession in 2008, commercial banks in the United States began accumulating huge cash reserves in their accounts at the Federal Reserve. By the middle of 2011, reserves had reached $1.6 trillion, more than 10 percent of U.S. GDP, an order of magnitude for commercial bank cash holdings that is without precedent. The key factor allowing banks to accumulate huge cash hoards was that the Federal Reserve had pushed the federal funds rate to near zero by the end of 2008, and held it there through 2011 and beyond. Over this same period, the non-corporate business sector obtained zero net credit. This overall pattern represents the most recent variant of reaching a “liquidity trap” and trying to “push on a string.” Under such circumstances, conventional central bank open-market operations are greatly weakened as an expansionary policy tool. This paper examines the experience of the liquidity trap in the United States since the Great Recession began to consider policy approaches for escaping the trap. I provide a critical review of various proposals for escaping liquidity traps, including raising the inflation target, depreciating the currency, and targeting long-term interest rates directly. I also propose two key innovative policies, an excess reserve tax for commercial banks and a major expansion in the federal loan guarantee program for smaller businesses.