Money Demand, Money Supply, Liquidity Trap

As very low interest rates, investors are indifferent between bonds and money – money demand becomes perfectly elastic. Increase in the money supply is held as cash.

Derivation of the LM-Curve With Liquidity Trap

As income falls below $Y_3$, no effect on the interest rate. The LM-curve is horizontal.
Monetary Policy in a Liquidity Trap

\[ \pi^e = 0 \]

The economy is at \( Y_0 \) below full employment potential. Monetary policy is ineffective in pushing the economy beyond \( Y_1 \).

Fiscal Policy in a Liquidity Trap

\[ \pi^e = 0 \]

But, fiscal policy seems to work and you get the full multiplier effect as you move from \( Y_0 \) to \( Y_1 \). Why do you get the full multiplier effect?
Fiscal Policy in a Liquidity Trap

\[ \pi^e = 0 \]

The Fed Targets the Interest Rate – Not the Money Supply

\[ \pi^e = 0 \]

Case where real sector of the economy experiences shocks causing shifts in the IS-curve. If the Fed targeted the money supply, go to points B' and C'.