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The role of the Capital Markets Union in avoiding the liquidity trap

The liquidity trap occurs when consumers and businesses show an absolute preference for holding cash rather than investing because returns are too low. This leads to the central bank no longer being able to influence financing conditions. How can Europe avoid the liquidity trap?

European households and corporates have hoarded a large share of the liquidity that governments and central banks have injected into the economy to combat COVID-19 pandemic. However, that does not mean Europe has already fallen into the liquidity trap. After all, Europeans have had little opportunity to spend amid strict lockdowns. When restrictions to demand were lifted temporarily in summer 2020, households considerably scaled back their savings. Moreover, productive investment has not decline further than GDP last year. In fact, it has increased continuously faster than GDP since the ECB introduced negative interest rates and QE in 2014. So, monetary policy does not seem to have lost all traction, and we will have to wait until well after the health situation normalizes to see whether COVID-19 has pushed Europe into the liquidity trap.

In the context of the EU's Capital Markets Union project, it is nevertheless unfortunate that the massive liquidity injected during the pandemic has not found a more effective use. Europe already had a huge pool of savings before COVID. The share of cash to financial assets held by companies has increased by two percentage points to an all-time high of 12.4% over the past three quarters. More than two-thirds of households' financial transactions last year landed in bank accounts, while less than 2% were used to increase direct equity holdings. Cash and deposits replaced equities as the main class of financial assets held by European households in 2008. Since then, the return on bank deposits has fallen to zero, while dividends on European equities offered a constant 3% per year. The unproductive use of EU savings is not only unfortunate for savers. It is also regrettable for SMEs in Europe which, as the IMF recently pointed out, suffer from a substantial equity gap of about 2%-3% of GDP (See IMF WP/21/56). This gap has widened due to COVID-19.

There are two ways to escape a liquidity trap, as Buiter and Panigirtzoglou described (See NBER WP 7245). The first is fiscal expansion. The second is for the central bank to lower the effective zero low bound on interest rates. COVID-19 has helped reduce the liquidity trap risk somewhat by triggering a bold policy response, both monetary and fiscal. The EU Green Deal would probably not have been endowed with €750 billion funding without the pandemic. EU budget rules would not have been relaxed. The ECB would probably not have pushed long-term yields further into negative territory and further loosened refinancing conditions for banks. The latter might positively influence banks' ability to charge negative interest rates on customer deposits, but the process remains slow and uneven, and still tilted more towards corporate deposits than households deposits (See Bundesbank Monthly Report February 2021 Box pp34-35).

While acting further on these two levers might alleviate the risk of falling into a liquidity trap, they would not make the allocation of savings in Europe more effective. This can only be achieved by completing the Capital Markets Union and, above all, by incentivizing retail investors to increase their direct or indirect holding in equities. Beyond the planned reviews of the regulatory framework for institutional investors (Solvency II, AIFMD, ELTIF, MiFID II/R, CRR2), access to independent financial advisers and improvements in savers' financial literacy are essential.

Positive tax incentives for retail investors would also help shift savings from bank deposits toward direct or indirect equity holdings if banks remain hesitant to pass negative interest rates to retail depositors. In a post-COVID world, the poor alternative to completing Capital Markets Union would be for EU states to fill the SME equity gap. This would necessitate direct participation financed by taxes. Europe can do better.

Capital Markets Union is vital to the economic recovery. It can help avoid the liquidity trap and spur investment by providing a better return on savings.