The Telegraph

Is QE a saviour, necessary evil or the road to perdition?

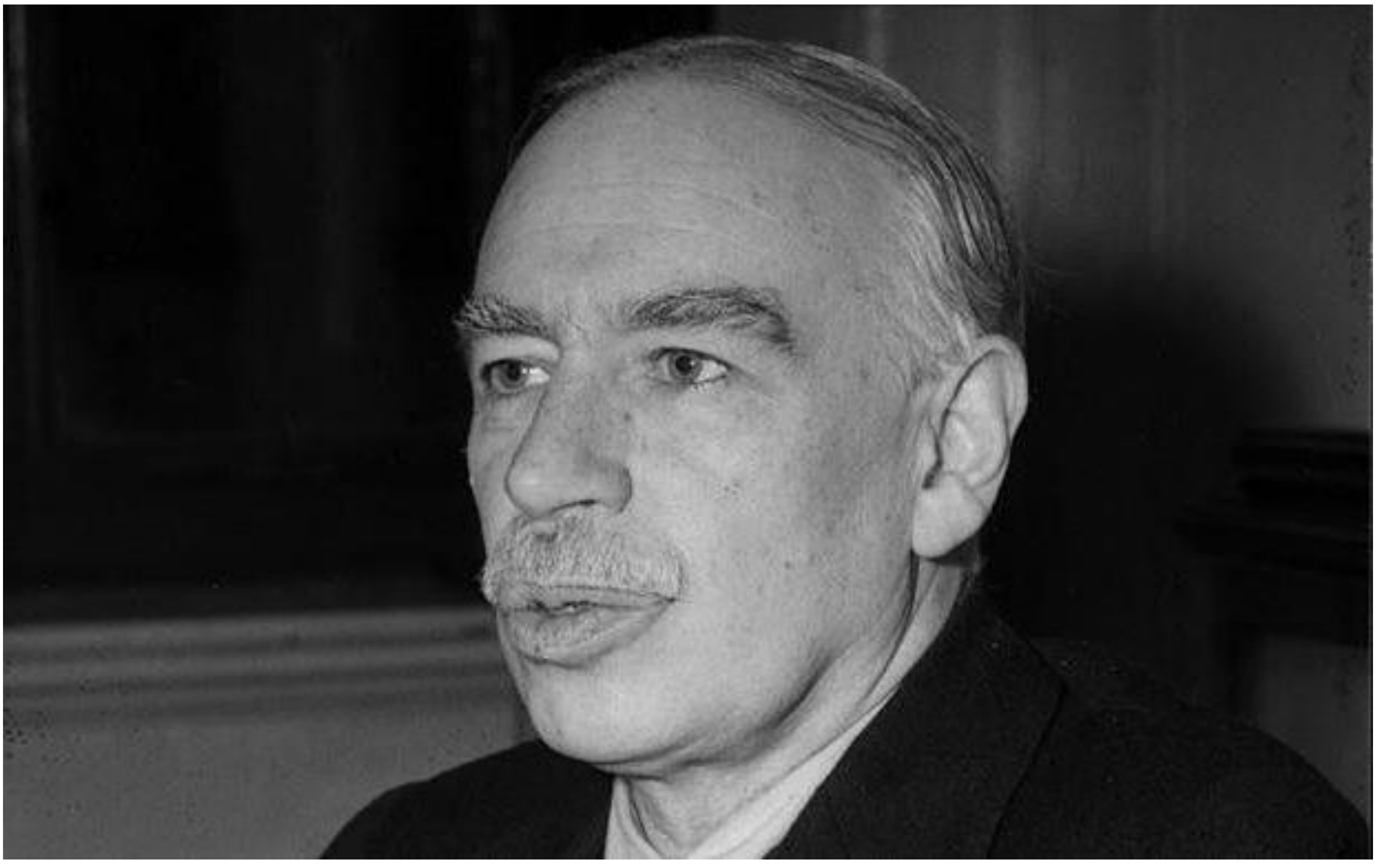
- ROGER BOOTLE

Two weeks ago, the European Central Bank announced a big increase in quantitative easing. The Bank of England and the US Fed, of course, have stopped QE but the effects of previous programmes continue in the system. As many readers have urged, it is high time to take stock.

During and after the financial crisis of 2007-09, QE made a huge contribution to stabilising the financial markets, helping to bring about economic recovery. But once recovery had been secured, what more QE achieved is questionable. And there have been some undesirable consequences. So, as with everything else in economics, the verdict is a matter of balance – of deciding when the minuses outweigh the pluses.

Under QE, the central bank buys financial assets in the markets (usually government bonds) with money that it issues itself, thereby increasing both sides of its balance sheet. In practice, hardly any extra notes are printed. Rather, the extra money is created electronically. But since deposits at the central bank are interchangeable with notes, to describe this as “printing money” is acceptable shorthand.

This policy sounds extraordinary, and perhaps even foolhardy. But it has featured in standard economics textbooks for generations (under the name Open Market Operations). Moreover, it was advocated not only by John Maynard Keynes, but also by Milton Friedman.


The great economist John Maynard Keynes was a supporter of QE CREDIT: AP

Mind you, there are limits to what it can achieve, and it is not for all seasons. But every so often the monetary system breaks down in a spectacular fashion. When that happens, the real sources of prosperity – hard work, investment and technological progress – are as nothing against the tsunami of monetary collapse. That’s when printing money comes in.

In the Great Depression in the US in the 1930s, output fell by 30pc and unemployment soared to 25pc. The money supply contracted by 25pc. Although different schools of thought argue about the precise causation, all agree that the monetary contraction played a huge role. At the time, the US Federal Reserve did little to stop this process. Indeed, it probably exacerbated it.

By contrast, after 2008-09, what could have been a re-run of the Great Depression was stopped in its tracks by much lower interest rates and QE. The Great Recession’s fall in output was minor compared to the 1930s: only 4pc to 5pc.

Some critics accept that without the intervention of the central banks there would have been an economic collapse, but they argue this would have been a good thing. A system purged of bad practices and bad institutions would have been healthier when the economy recovered.

Yet it wasn’t obvious that the collapse of the 1930s provided a beneficial purge. In Germany, it led to the rise of Hitler. And in the US, the misery of the soup kitchens was only overcome towards the end of the decade once war production raised aggregate demand.

It can be argued QE could have lessened the impact of the Wall Street Crash and Great Depression CREDIT: CSU ARCHV/EVERETT / REX FEATURES

Other critics argue that the recovery created by QE is only temporary and that the system will either succumb to a burst of hyper-inflation or fall into a new crisis under the impact of the financial distortions created by QE.

But much higher inflation is not the inevitable consequence of all this money creation. The policy can be put into reverse, as the central banks can offload the bonds they have bought. Equally, they can impose reserve requirements on the banks to absorb excess cash and they can raise interest rates.

The example of Zimbabwe, which printed boatloads of money and succumbed to hyper-inflation, is not a case of QE gone wrong. It was the result of government incompetence in being unable to raise sufficient taxes to cover expenditure on a gross scale and resorting to money printing to cover the gap.

In fact, when the monetary crisis is over and yet the monetary system remains severely impaired, it is questionable whether buying government bonds, which are themselves liquid and supposedly of unimpeachable credit quality, with liquid deposits at the central bank will do very much at all. It may just be irrelevant. In principle, of course, it may help one country by depreciating its exchange rate. But even that channel didn’t appear to work last week for the ECB. And, of course, currency depreciation is not a solution for everyone.

QE has created a bubble in some assets CREDIT: BARCROFT MEDIA

As to the distortions created by QE, they are certainly there. There is currently a quasi-bubble in government bonds. Moreover, parts of the property market, both here and overseas, look overblown – and therefore dangerous. As it happens, I think these distortions are more due to the policy of sustained very low interest rates than to QE. But QE hasn't helped.

QE also has a serious distributional aspect. Insofar as it has worked by boosting asset prices, it has favoured those with assets while helping to depress returns to savers. And, operating through the banks, it can be said to have propped up banks and bankers – which is widely regarded as a decided negative in America, if not here. (This leads on to the question of whether so-called "helicopter drops" of money, bypassing the banks, would be much more effective – and equitable. I will deal with that another time.)

We must surely all hope for an early return to monetary "virtue" – even though, following St Augustine, I would plead "not yet". In fact, if there were to be another monetary implosion, I would support more QE. For recovering economies, such as the US and the UK, though, QE has already reached, and perhaps surpassed, the limits of its usefulness.

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