

Marketplace



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'Quantitative easing prevented the Great Recession from becoming the Second Great Depression'

A favourite bogeyman of much economic commentary in the last two years has been "quantitative easing" (QE). Controversy has been sharpened by the early November decision of the US Federal Reserve to buy \$600 billion of long-dated Treasury bonds and a subsequent statement from Ben Bernanke, the Fed's chairman, that it will increase the purchases if necessary. These operations have been dubbed "QE2" by financial markets because they follow a previous spate of Fed asset purchases in late 2008 and early 2009.

QE2 has provoked outrage among a large section of the commentariat. The standard characterisation is that it constitutes "the printing of money" and so is necessarily inflationary. In his influential *Interest Rate Observer*, the American pundit James Grant lamented that QE2 was "the start of a new adventure in money printing". Like many monetary conservatives of the backwoods persuasion, he praised gold for its ability to retain its real value despite the printing presses and other iniquities of the modern world. In Britain, Liam Halligan of Prosperity Capital Management has expressed similar views in the *Sunday Telegraph*, although his wrath goes back to the Bank of England's embrace of QE in March 2009. In his words, quantitative easing is "a polite, yet intellectually dishonest name for 'money printing'".

Of course, the phrase "printing money" is pejorative. The underlying thought—or should one say the implicit prejudice—is that money un-backed by tangible assets is inflationary, irresponsible and bad. Our great-grandparents believed that the convertibility of paper money into a precious metal helped to define civilisation. But modern monetary conservatives—such as Keynes and Friedman—understood that the gold standard left too much to chance. They saw that under the gold standard or indeed any precious metal standard the quantity of money depended too much on the accidents of mining technology and geological discovery. They argued that the best arrangement was for the state to manage the quantity of money.

In the 15 to 20 years of the Great Moderation, running up to the banking crisis of 2007, the world combined man-made fiat currency with stable low inflation, steady output growth and high and rising employ-

ment. During the Great Moderation, central bankers saw monetary stability as, above all, concerned with preventing a return to *inflation*. But from summer 2007, and more particularly from autumn 2008, the game changed. The quantity of money stopped growing. As the advanced countries entered the Great Recession, the new policy challenge was to avoid *deflation*.

The details of QE operations are of mind-blowing complexity, although their essence—the creation of money by the state—is straightforward. To repeat, the dominant monetary assets of our times are bank deposits. As deposits are liabilities of the banking system, their growth depends on that of banks' assets. What went wrong in mid-2007 was that banks' claims on the private sector started to shrink. If nothing had been done, the quantity of money would also have declined and deflation would have set in.

But the recessionary forces could be easily checked by the state replacing the private sector as the principal new borrower from the banking system and, hence, by becoming the main creator of money. That was and remains the purpose of the operations, the diverse and manifold operations, which come under the label "quantitative easing". If the leading central banks display enough intelligence (which admittedly remains far from certain), QE operations can be designed and calibrated to ensure that the total of bank deposits grows at a rate consistent with macroeconomic stability.

What has this to do with "money printing"? Far less than the backwoodsmen think. The Bank's QE exercise began in March 2009 and ended in February 2010, with £200 billion of asset purchases. Did that mean that the note issue also rose by £200bn? No, it didn't. The Bank return shows that notes in circulation were £45.5bn in March 2009 and £49.5bn in February 2010. In other words, money printing as such was only £4bn and was little more than 2 per cent of the programme.

QE prevented deflation, as Britain's current inflation is about 3 per cent. It worked not because of its effect on money printing and the note issue, but because it ensured that the quantity of money—broadly defined to include all bank deposits—did not fall too heavily. QE prevented the Great Recession from becoming the second Great Depression, and for that we should be grateful.